C.D. Howe Institute
Commentary

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Now That the Coat Fits the Cloth...

Spending Wisely in a Trimmed-Down Age

John Richards

In this issue...

To avoid a repeat of the fiscal excesses of the past 25 years, Ottawa and the provinces should pursue a more disentangled federalism: greater tax-spending coincidences among the provinces and a clearer constraint on the federal spending power.

The Study in Brief...

The federal government and almost all the provinces have now achieved — or almost achieved — fiscal balance. Without deficit elimination as a lens to focus public debate, they face a bewildering contest among interest groups that are staking diverse claims for program spending and for tax and debt reduction.

How should Canadian governments resolve that tug of war without returning to the economically and politically destabilizing inefficiencies of the past several decades?

The answer, this *Commentary* suggests, lies in remembering that Canada, like almost all members of the Organisation for Economic Co-operation and Development, is essentially a welfare state — one in which the largest part of peacetime government spending goes to social programs, including significant income redistribution through taxes and transfers. But in any modern democracy, citizens must balance their demands against their willingness to pay taxes. Bearing on individual preferences are the lobbying efforts of interest groups committed to advancing particular programs and to pursuing more or less public spending and taxation.

To prevent these conflicting strategies from having a harmful effect, Canadians must call on their considerable store of *social capital*, an imprecise but useful term drawn from political science. The World Bank defines it as "the informal rules, norms, and long-term relationships that facilitate coordinated action and enable people to undertake cooperative ventures for mutual advantage."

The implication, the *Commentary* says, is that Canada's federal and provincial governments should work toward cooperative solutions to fiscal arrangements that focus on:

- respecting the principle of tax and expenditure coincidence (excepting equalization payments to the "have-not" provinces);
- submitting the federal spending power to increased consensus from the provinces before Ottawa spends in areas of their jurisdiction;
- stabilizing federal and provincial government program spending as a share of gross domestic product over the business cycle (because current public demands are primarily in areas under provincial jurisdiction, the provinces can be somewhat less frugal than Ottawa);
- realizing modest tax cuts, with Ottawa taking the lead.

The Author of This Issue

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By the mid-1990s, a majority of Canadians accepted that two decades of cutting the public coat larger than the cloth available had led to ill-fitting garments that cost too much. Moreover, they were dubious about resolving the problem by giving politicians ever-larger bolts of cloth. What then transpired is not surprising in retrospect: politicians found ways to cut the public coat to the size of the cloth available, and usually — but not always — voters rewarded them for doing so.

The question now arises, how to get the best coat possible out of the cloth that citizens are prepared to pay for?

That question is simple to state, less easy to answer. A satisfactory response must address the ability of Canadians to achieve mutually acceptable solutions — their ability to generate what political scientists have come to call "social capital."

In outline, this *Commentary* proceeds as follows. Following this introduction is an informal exploration of the imprecise idea of social capital and its relevance to discussions of government size and decisions. Then come some comments on what the World Bank labeled the fiscal crisis of the welfare state; in particular, I note parallels among Italy, Belgium, and Canada, three highly indebted welfare states. In Canada, fiscal redress involves the provinces as much as Ottawa, and, after examining the fiscal trajectories of the 11 senior governments over the past decade, I attempt to draw conclusions about the political compromises whereby Canada achieved fiscal balance during the 1990s.

The *Commentary* concludes with some recommendations in answer to the above question. They focus on the following:

- achieving greater tax and expenditure coincidence among the provinces;
- introducing effective constraints on Ottawa's use of its spending power in areas of provincial jurisdiction;
- finding stable targets for federal and provincial program spending relative to gross domestic product (GDP); and
- realizing modest tax cuts.

Social Capital: A Tentative Introduction

When its debt-to-GDP ratio peaked in 1996, Canada ranked third among the countries of the Organisation for Economic Co-operation and Development (OECD) in terms of the relative size of net public debt.[1] Incurring a large public debt was the inevitable

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1 Canada ranked third in terms of net public debt, fourth in terms of gross public debt. The difference in the rankings is attributable to the absence of Greece from the net debt rankings. According to the OECD (no. 66, tables A34, A35), the 1996 debt-to-GDP ratios for the four top countries were:

	Gross Debt	Net Debt
	(percent)	
Belgium	127	120
Italy	122	109
Greece	111	n.a.
Canada	99	69

At the nadir, between 1991 and 1993, Canada's deficit placed it below the bottom quartile of OECD countries (among the quarter with the largest deficits relative to their GDP).

consequence of running chronic deficits. At the nadir, between 1991 and 1993, Canada's deficit placed it below the bottom quartile of OECD countries (among the quarter with the largest deficits relative to their GDP). Over the 1990s, most OECD countries improved their fiscal stance, but Canada undertook an exercise in fiscal redress that was more ambitious than most. Accordingly, it moved dramatically up the ranks. Since 1996, it has been close to or above the top quartile (that is, among the quarter realizing the smallest relative deficits or, for a few including Canada, posting surpluses).

Canada's fiscal redress entailed controversial initiatives by both orders of government. By the end of the 1990s, program spending in Canada had shrunk by nearly 10 percentage points of GDP from its peak early in the decade, returning to ratios prevailing in the late 1970s. Larger reductions took place only in Finland and Sweden, two Nordic countries that, for various reasons, also experienced wrenching adjustments in their public sectors. (See Table 1.)

Leaving aside a few provincial laggards, the finance ministers of Canada's 11 senior governments no longer have deficit elimination as a lens to focus public debate. They now face a bewildering contest among interest groups that are staking diverse claims for program spending and for tax and debt reduction.

What Is Social Capital?

In thinking about the country's recent exercise in fiscal redress and its ongoing exercise in establishing fiscal priorities, a useful concept is that of *social capital*, a term political scientists use to refer to the ability of organized groups within a country (or region) to reach mutually acceptable solutions in pursuit of collective goals and of citizens to have confidence in one another's behavior when participating in voluntary associations or commercial exchange.

The idea has at least two interpretations. The first treats social capital as a characteristic of relations among agents who represent organizations, which may be formal (corporations, unions, political parties) or informal (neighborhood interest groups, ethnic and religious associations). According to this first meaning, high social capital means that leaders of these organizations, even when competing against one another (say, in elections or in markets), use strategies that entail important elements of cooperation.

The second meaning treats social capital as a set of values or norms that people acquire over time, norms that enable them, as individuals or members of groups, to interact with others on the basis of trust. The two interpretations are not independent: a history of cooperative relations among organizations breeds trust among individuals; a history of noncooperative interactions does the opposite. (Members of a group may, however, display high social capital in dealing with one another, yet low social capital in dealing with nonmembers.)

Where social capital is high, voluntary associations dedicated to the realization of local collective goals thrive, political corruption is the exception, and citizens expect to be free from the arbitrary use of state or vigilante force. Laws voted by democratically legitimate legislatures provide a reasonably accurate view of the actual policies of government leaders, and budgets accurately reflect tax and expenditure plans. Citizens enter into commercial contracts with expectations that all parties will honor them and that the courts will provide expeditious redress should one party violate the contract.

Table 1: *Changes in Program Spending, 19 OECD Countries, 1990–99*

	Maximum in 1990–94		Minimum in 1995–99		Change (3 – 1)
	(1)	(2)	(3)	(4)	(5)
	(% of GDP)	(year)	(% of GDP)	(year)	(% points)
Australia	34.0	1993	30.5	1999	– 3.5
Austria	49.5	1993	46.1	1998	– 3.4
Belgium	46.1	1993	43.6	1998	– 2.5
Canada	46.0	1992	36.4	1999	– 9.6
Denmark	57.4	1994	52.5	1999	– 4.9
Finland	59.5	1992	45.6	1999	– 13.9
France	51.0	1993	49.3	1997–98[a]	– 1.7
Germany	45.6	1993	44.3	1998	– 1.3
Greece	41.1	1993	40.4	1996	– 0.7
Ireland	34.4	1994	28.1	1999	– 6.3
Italy	44.9	1993	41.0	1997–98[a]	– 3.9
Japan	34.4	1994	34.0	1997	– 0.4
Netherlands	45.6	1992	39.3	1998	– 6.3
Norway	54.9	1992	45.5	1997	– 9.4
Portugal	39.1	1993	38.2	1995	– 0.9
Spain	41.6	1993	35.0	1999	– 6.6
Sweden	66.9	1993	53.5	1999	– 13.4
United Kingdom	43.2	1992–93[a]	36.9	1999	– 6.3
United States	31.1	1992	27.3	1998–99[a]	– 3.8
Average	45.6		40.4		– 5.2

[a] Identical values occurred in the two years indicated.

Source: Author's calculations from data in *OECD Economic Outlook*, no. 66.

In many countries where social capital is low, little of the above holds. Collective political undertakings function only among those loyal to the same party, and loyalties depend on groups defined by extended family, class, religious, or ethnic bonds. Citizens outside the relevant governing interest group have — often with good reason — limited trust in the predictability and fairness of political or legal decisions. In the absence of confidence in the state's willingness to enforce contracts, complex commercial agreements are restricted to parties among whom prior trust exists due to family networks or religious or ethnic traditions.

The World Bank provides the following definition of social capital: "the informal rules, norms, and long-term relationships that facilitate coordinated action and enable people to undertake cooperative ventures for mutual advantage" (1997, 114). In an important book on social capital, Fukuyama defines it as "the ability to work together for common purposes in groups and organizations." He goes on:

> The concept of human capital...starts from the premise that capital today is embodied less in land, factories, tools, and machines than...in the knowledge and skills of human beings....[A] distinct portion of human capital has to do with people's ability to associate with each other, that is critical not only to economic life but to virtually every other aspect of social existence as well. The ability to associate depends, in turn, on the degree to which communities share norms and values and

> are able to subordinate individual interests to those of larger groups. Out of such shared values comes trust, and trust...has a large and measurable economic value. (1995, 10.)

Fukuyama stresses the asymmetry between the accumulation of social capital, and its destruction, which can take place rapidly.

Fukuyama stresses the asymmetry between the accumulation of social capital, which, even under optimum conditions of citizens' consistently pursuing cooperative strategies, takes place gradually, and its destruction, which can take place rapidly.

> The accumulation of social capital, however, is a complicated and in many ways mysterious cultural process. While governments can enact policies that have the effect of depleting social capital, they have great difficulties understanding how to build it up again. (Ibid., 11.)

The idea of social capital is maddeningly imprecise. Analysts are tempted to use it tautologically: to assert that social capital is high in discussing social relations of which they approve and, *mutatis mutandis*, to claim it is low. Nonetheless, the concept has something to it. "If physical capital is wholly tangible, being embodied in observable material form, and human capital is less tangible, being embodied in the skills and knowledge acquired by an individual," writes Coleman (1999, 19) in a seminal article, "social capital is less tangible yet, for it exists in the *relations* [his emphasis] among persons."

In attempts to measure the idea (at least the second interpretation of it), much is made of public response to the disarmingly simple question posed by the World Values Survey: "Generally speaking, would you say that most people can be trusted or that you can't be too careful in dealing with people?" This question has been repeatedly posed, for four decades, to thousands of interviewees in countries around the world. In general, trust in western European and North American countries is high. Since the 1950s, convergence has occurred, partly through a rise in social capital (as measured via this question) in continental Europe and a decline in the United Kingdom and the United States (Helliwell 1996, 4).

The World Bank is a major source of research on the link between social capital and economic growth. Given the potential controversy of wealthy donors' criticizing the conduct of poor recipient countries, its conclusions are stated diplomatically. Nonetheless, current World Bank policies place great emphasis on engaging civil society as a precondition to the efficient functioning of both the state and markets. "[I]n countries with weak institutions and policies," the Bank concludes, "the focus needs to be on supporting reformers rather than disbursing money." In the absence of "champions of reform with long-term visions at the local or national level," results are likely to be mediocre (1998, 116).

Plus ça change, plus c'est la même chose...

In the short run, social capital may not come much into play in determining the policy or size of government in democratic, developed countries because trends in government revenue and expenditure and the consequent fiscal balance are heavily influenced by nondiscretionary features of program design. Examples include

expenditures on core social programs, such as old age security, where outlays are determined by demographic variables superimposed on a given policy framework, and unemployment insurance, where, with any given set of regulations, expenditures vary inversely with the health of the labor market.

In the long run, the relative size of government depends on hard-to-specify considerations that differ across countries and change over time within countries. One can, however, make some modest statistical generalizations.

From 1960 to the peak in the early 1990s, the median for government spending as a share of GDP among OECD countries nearly doubled.

From 1960 to the peak in the early 1990s, the median for government spending as a share of GDP among OECD countries nearly doubled (see Figure 1).[2] The basic explanation is that citizens in all those countries voted to increase substantially the social programs that, in peacetime, comprise the largest part of government program spending. In Canada, a reasonable estimate of spending falling within the ambit of the welfare state is about two-thirds of program spending.[3]

In any modern democracy, citizens must balance their demand for public services — here including significant income redistribution using government tax-transfers — against their willingness to pay taxes. Bearing on individual preferences are the lobbying efforts of interest groups committed to preserving and advancing particular programs. Those opposed form other interest groups. Political parties construct coalitions among interest groups and attempt to persuade a plurality of voters to pursue programs that entail, according to their platform, more or less public spending and taxation.

As illustrated by Figure 1, the ranking of public sectors by size across OECD countries displays a good deal of stability. Since the 1970s, governments in the Scandinavian countries have been relatively large, and those in the United States relatively small. Per capita GDP is high in all four country groupings included in the figure. Although some analysts (such as Chao and Grubel 1998) attempt to establish the optimum size of government to maximize economic growth, the relationship between per capita GDP and size of government is not particularly strong, which suggests that a productive market economy is potentially consistent with governments of widely differing relative size.

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2 My references throughout are to the 19 OECD countries for which continuous data stretch back to 1960. They are the Group-of-Seven countries — Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States — and the following 12: Australia, Austria, Belgium, Denmark, Finland, Greece, Ireland, the Netherlands, Norway, Portugal, Spain, and Sweden.

3 I define a country's welfare state as simply the sum of its social programs. The two-thirds estimate is based on the following calculation. For fiscal year 1999/2000, Ottawa proposed program spending of $97 billion (including $6 billion in tax expenditures via the Canada Child Tax Benefit but excluding transfers to other governments). Social program spending items sum to $56 billion. Included as social programs are the following items: elderly benefits, employment insurance (EI) benefits, agricultural subsidies, international aid, and the budgets of several departments (Health, Human Resources Development, and Indian and Northern Development), and of the Canada Mortgage and Housing Corporation (CMHC). By this categorization, federal social program spending is 58 percent of all program spending. At the provincial level, the ratio is higher. Social program spending in Saskatchewan, for example, is estimated at $3.6 billion for 1999/2000, which is 75 percent of total program spending of $4.8 billion. Included as social program spending are the following: agriculture, education, health, and social services. So defined, spending on social programs makes up 58 percent of Ottawa's program spending and 75 percent of provincial program spending. Given the split between federal and provincial program spending (Ottawa spends slightly less than do the provinces in aggregate), the overall share of welfare state spending in federal-provincial budgets is two-thirds. (Canada 1999b; Saskatchewan 1999.)

Measuring the Middle

The most frequently used statistic to measure the central tendency among a set of numbers is the *average* or *mean*. It is simply the sum of the relevant observed numbers divided by the number of observations.

Another statistic to measure central tendency is the *median*. If the observations are ranked by size, the median is the numerical value such that half the observations are larger and half are smaller. The average and median are identical if the observations are symmetrically distributed.

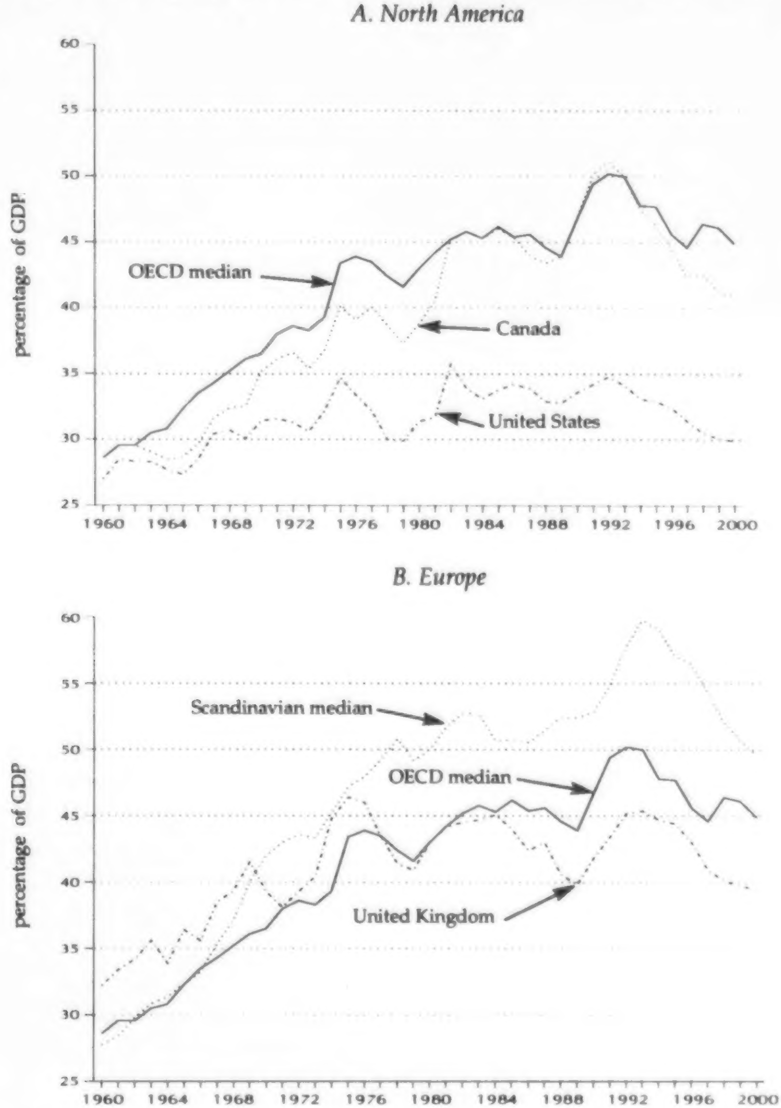
Another way to measure the middle is to define a range encompassing most of the observations but excluding those that are exceptionally small or large. The meaning of "most" and "exceptionally small or large" is obviously imprecise. Here I use the interquartile range. Once again, observations are ranked by size and broken into four groups, each containing one-quarter of the total. A *quartile* marks off each division. The *interquartile range* is the distance between the bottom quartile and top quartile; it thus encompasses half of all observations. The lower bound to this range, the *bottom quartile*, is the value such that one-quarter of observations are smaller and three-quarters are larger. Analogously, the *top quartile* is the value such that three-quarters of the observations are smaller and one-quarter are larger. The median obviously falls within the interquartile range, exactly in the middle of the range if the observations are symmetrically distributed.

What determines whether a country ranks high or low in terms of size of government? A useful way to address this question is to consider the strategies employed by domestic interest groups and political parties as they pursue their collective ends. If country A realizes what interest-group members generally accept as mutually satisfactory solutions, then it can simultaneously sustain a large, yet reasonably efficient, public sector and a productive market economy. And if interest groups and individuals in country B create a political culture characterized by noncooperative strategies, then the productivity of incremental public sector activity is likely to be low, even when government is small and performs few tasks. In equilibrium, country A will have the proportionately larger public sector, though random adverse economic shocks may induce deficits in either A or B. Given the prevalence of noncooperative strategies in B, returning to fiscal equilibrium is likely to be more protracted than in A.

The previous paragraph suggests that, *ceteris paribus*, countries with more cooperative cultures of interest-group bargaining generate, in equilibrium, larger public sectors. That statement is a drastic oversimplification. Let me provide a few immediate qualifications:

- The equilibrium size of GDP is not a monotonically rising function of interest-group cooperation. Even in countries, such as those of Scandinavia, that display exceptionally high levels of cooperation, other variables impose a ceiling — at perhaps 50 percent — to the efficient size of the public sector. If one ignores the severe fiscal crisis of the early 1990s, the median size of the public sector among Scandinavian countries has been about 50 percent of GDP for two decades.
- Some countries, such as the United States and Japan, score well by standard measures of interpersonal trust and cooperation yet have opted for relatively small public sectors. A high level of trust enables these countries to sustain particularly dynamic and efficient market economies. In these countries, certain functions of the

Figure 1: *Government Outlays, Selected Countries and OECD Median, 1960–2000*



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

welfare state — health insurance is an obvious example in the case of the United States — are performed primarily within the private market. These functions may not be performed as well as in countries with efficiently run public sector programs, but the inadequacies do not prompt major dissension.

- Countries at the other end of the government-size distribution may harbor interest-group bargains that are seriously inefficient. France, for example, was above the top quartile of government spending over the 1990s. A key component of French *dirigiste* arrangements among major unions, employers, and political parties are labor laws that, relative to those in Britain and North America, significantly restrict

wage dispersion and employers' freedom to hire and fire.[4] The result has been inefficiently high underemployment among young and low-skilled workers. Over the 1989–98 decade, French unemployment averaged more than 11 percent, and it was never less than 9 percent (*OECD Economic Outlook*, no. 66, table A22).

Cooperation means that interest groups accept the rules of the political game as legitimate, and more or less obey other unwritten norms surrounding political activity.

The pursuit of cooperative strategies does not mean identity of interest. Some amount of conflict is as integral to politics as competition is to the marketplace. Cooperation means that interest groups accept the rules of the political game as legitimate, and more or less obey other unwritten norms surrounding political activity. And, in private markets, agents obey both the letter and the spirit of contract law.

Criteria used in the literature as proxies for a high-cooperation society include a low rate of litigation, low strike/lockout rates in the public and private sectors, high indexes of honesty among public officials, and low default rates on commercial contracts. Where interest groups resort to noncooperative strategies, the political arena is likely to contain many inefficient arrangements that cannot be undone or amended because each contending group mistrusts the strategic response of others; each opts for the devil it knows over an alternate outcome that might in aggregate be more efficient but under which particular interests fear they would be worse off.

Usually, the patterns of cooperation and its opposite among citizens and interest groups are stable within a country or region. But this datum is not fixed; the distribution can change as a function of the strategies pursued by interest groups. Here, history matters. Many countries contain deep-rooted conflicts in which particular interests can — often with justification — claim to have been victims. If today's leaders so desire, they can exploit the historical injustice and persuade the relevant interest group to pursue a noncooperative strategy *vis-à-vis* other interests in the society.

Those other interests may initially behave passively, but eventually they respond. Ideally, their response is to invest in the restoration of civility, but groups may instead pursue tit-for-tat noncooperation. Grievances may be based on past injustices in the treatment of ethnic, religious, or regional groups. Class has also bedeviled social relations in industrial countries. Britain is the prime example of an industrialized country in which union leaders have frequently opted for militancy based on historical injustices. In the short run, such militancy may succeed; in the longer run, it provokes reaction.

The paragraphs above give an intuitive introduction to the debate on social capital that has assumed a high profile in the comparative analysis of the factors underlying government effectiveness. The root idea is that a necessary precondition for productive public and private sectors is the prevalence of a culture in which cooperation along many dimensions is the normal strategy adopted by interest-group leaders and by individuals.

The ability of a country to achieve fiscal balance is one proxy for the existence of a cooperative political culture (Helliwell 1996), an idea I return to below. Another is majority acceptance of international free trade arrangements. Relative to a closed economy, free trade increases an economy's exposure to international price fluctuations and heightens employment instability in sectors exposed to trade. Inevitably, it

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4 French labor laws have become more restrictive in the past decade. Consider, for example, recent legislation to restrict the work week to 35 hours.

generates short-term winners and losers among interest groups. If domestic interests expect cooperative political outcomes, they have confidence that, in the event of serious adverse market events, those suffering losses will be compensated (by easy access to alternate jobs in a full employment economy, by social insurance programs, and by publicly funded mobility and training programs). If, however, interest groups have settled into noncooperative strategies, they may well choose to veto free trade arrangements, even as they acknowledge that trade specialization has the potential to augment aggregate economic productivity.

Over the past three decades, Canada and Britain have joined regional free trade blocks. Interest groups in these countries have thus proved willing to cooperate. However, domestic debates over participation in free trade arrangements were more acrimonious than analogous debates in many other states — for example, among the continental members of the European Union (EU).[5]

In Canada, a coalition of unions and nationalist interest groups adamantly opposed the proposed Canada-US Free Trade Agreement (FTA) in 1988. Their intervention led to an ideologically polarized general election (probably the most polarized since an election on the same issue in 1911). The Liberals, who lost the 1988 election, vowed to continue what then-leader John Turner described as a crusade against the FTA, and they campaigned in 1993 on an ambiguous promise to abrogate the FTA and the North American Free Trade Agreement (NAFTA).[6] Not until the Liberals, once elected, endorsed the NAFTA did the framework for Canadian commercial policy with the United States become reasonably certain.

Something similar took place when Britain entered the European Community (as it was known at the time) under a Conservative government in 1973. When Labour came to power in 1974, adamant union opposition to that entry meant that the country's intentions remained unclear. Unions obliged the government to conduct a national referendum on the matter in 1975, and only when a majority endorsed British entry was the matter effectively settled.

5 The Scandinavian countries are somewhat an exception to the conclusion that low cooperation is a barrier to a country's participation in free trade arrangements. For many years, the majority in Scandinavia feared that participation in the EU would oblige them to reduce the generosity of their welfare states. The Danes joined after two referendums, and Norway has remained out. Serious domestic fiscal crises in the early 1990s disabused many Swedes and Finns about their ability to extrapolate past divergence in social policy from the European norm. While public spending remains above average in both, these two countries have experienced larger percentage-point reductions in public spending than Canada over the 1990s (see Table 1). A convergence to the median, combined with the importance of stable relations with European trading partners, persuaded a small majority of Swedes to opt for entry into the EU in a 1994 referendum. Similar motives — plus an understandable desire for diplomatic protection against Russia — prompted Finland also to join. See Mellbourn (2000) for a discussion of current Scandinavian opinion.

6 Prior to the 1993 election, the Liberals produced a 112-page election manifesto (the Red Book). On the subject of free trade relations with the United States, it says:

> A Liberal government will renegotiate both the FTA and NAFTA to obtain a subsidies code, an anti-dumping code, a more effective dispute resolution mechanism, and the same energy protection as Mexico. Abrogating trade agreements should be only a last resort if satisfactory changes cannot be renegotiated. (Liberal Party of Canada 1993, 24.)

... mais pas toujours

Currently, both the United States and Britain have public sectors below the median size. This was not always so. In the early 1960s, the United States was close to the median, and Britain above it.

Britain

The British public sector remained above or at the OECD median until the second half of the 1970s, a point of discontinuity in that country's public life. At the time, a Labour government was attempting to mediate numerous collective bargaining disputes, in both the private and public sectors, within a context of unexpected jumps in world oil prices and union militancy. Widespread public sector strikes in 1978–79 (the so-called winter of discontent) symbolized a generalized breakdown of the ability of interest groups and government to realize mutually satisfactory outcomes. While a minority accepted a class-based union explanation for the failure ("the fault lies with the bosses and sold-out Labour politicians"), the plurality accepted a conservative populist interpretation: unions had grown too politically powerful and were pursuing unduly aggressive and inefficient strategies in collective bargaining; the Labour government was stifling private enterprise. The Conservatives under Margaret Thatcher won the 1979 election and relegated Labour to continuous opposition until 1997.

Much about Britain is consistent with the social capital thesis.

Much about Britain is consistent with the social capital thesis. In the years immediately following World War II, the country experienced a high level of cooperative behavior that enabled successful social program innovations, the most important of which was universal health insurance (the National Health Service). A quarter-century later, people used the phrase the "British disease" as a summary description for any country suffering chronically high inflation, low productivity growth, an acrimonious industrial relations environment characterized by a high strike/lockout rate, and intense ideological conflict in the political arena.

Between 1960 and the mid-1970s, Britain and the Scandinavian countries increased the relative size of their public sectors. At the time, there was little to suggest that a large divergence in relative size would emerge after 1980 (see Figure 1, panel B). However, the Scandinavian countries expanded their public sectors in a context of reasonable social agreement, respectable productivity growth, and balanced budgets; the same was not true in Britain, which was incurring above-average deficits.[7]

British social consensus deteriorated in the three decades following World War II. Given limited consensus, the equilibrium size of British government has probably been below the OECD average over the past quarter-century. The emergence of New Labour under Tony Blair may mark a new departure. Its leaders have recognized the inefficiencies attendant on the tax and spend policies of Old Labour in the 1970s and have persuaded allied interest groups, notably the unions, to accept the legitimacy of balancing the budget subject to present overall tax rates. If it sustains broad support,

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7 Parallels exist between the discontinuity in British politics of the late 1970s and Scandinavian politics of the early 1990s. In both cases, the traditional union-based Left had advocated growth in public spending beyond what other interest groups considered acceptable. And in both instances, external economic shocks served as a catalyst precipitating reduction in the relative size of the state.

New Labour may somewhat raise the equilibrium size of the British public sector. But to date, it has not done so. The peak size of the British public sector over the past four decades took place in 1976; its projected value in 2000 is essentially unchanged from that bequeathed to Labour by the Conservatives in 1997.

The United States

In the United States during the 1960s, the collective memory of successful New Deal programming during the Great Depression was still alive. Social experiments under President Lyndon Johnson (the Great Society programs) can be considered the last chapter of Washington-centered New Deal activism. The combination of social programs and large military spending led, at the time, to the US public sector's remaining within 4 percentage points of the OECD median in the 1960s. The small-government US tradition became evident only in the 1970s (see Figure 1, panel A).

Why has the United States become an outlier in terms of relative size of its public sector? The potential explanations are many. Some commentators consider the New Deal tradition an aberration, lasting from the 1930s to the 1960s, in a country with an essentially antistatist popular culture (Lipset 1986; 1989). Others argue that the decline in participation in voluntary associations is a key variable that, in turn, has led to a decline in both social capital and the productivity of government activity (Putnam 1995).

Fukuyama (1995) stresses the US proclivity to translate interest-group conflicts into competing rights to be litigated, rather than competing claims to be accommodated by state or national legislators. The legitimacy of the courts as institutions to resolve interest-group conflicts has increased over the past half-century in both the United States and Canada. Whatever the cause of this shift in relative legitimacy, activist judges have frequently supplanted politicians. (An obvious example is in race relations, undoubtedly the most intractable interest-group conflict in US society.)

The danger of translating political claims into rights claims is that it lowers the incentives to undertake efficient compromise.

The danger of translating political claims into rights claims is that it lowers the incentives to undertake efficient compromise. A rights culture encourages interest groups to define and pursue uncompromising strategies based on the affirmation of particular rights, to deny legitimacy to the claims advanced by others, and to prefer the art of litigation over the art of politics. As Fukuyama summarizes, "[T]he American language of rights gives political discourse in the United States an absolute and uncompromising character that it need not have" (1995, 315). A rights culture invites interest-group protagonists to portray their respective claims as the only legitimate basis for public policy. "What is particularly insidious about the American culture of rights," he concludes, "is that it dignifies with high moral purpose what often amount to low private interests or desires" (ibid., 316).

The Fiscal Crisis of the Welfare State

The welfare state is a massive, ongoing exercise in interest-group compromise: over the level of taxation to impose on the nonpoor and the obligations to place on the poor who receive transfers, over the salary levels of public sector workers, over the differences between advocates of more schools and advocates of more hospitals, and so on. A political culture that disparages the art of effective political compromise is

A political culture that disparages the art of effective political compromise is unlikely to generate an effective welfare state.

unlikely to generate an effective welfare state. Activist judges can force schools to desegregate; they cannot turn bad schools into good schools.

The World Bank devoted its 1997 World Development Report to the theme of state effectiveness. It opened with a discussion of major global problems, among them "the fiscal crisis of the welfare state in most of the established industrial countries"(1997, 1). The reference was to the fact that, for a quarter of a century, the median OECD country's public accounts have been in deficit. Deficits have been larger in recessions than in booms, but until the mid-1990s, the trend appeared to be toward ever-larger deficits. (See Figures 2–4.)

The growth of the welfare state since World War II has greatly improved the lives of ordinary citizens. In all OECD countries domestic interest groups have formed to promote particular programs — which was to be expected. What was not expected in mid-century, however, is that in many countries these groups would seriously challenge the legitimacy of elected legislatures engaged in the exercise of balancing budgets. In particular, interest groups challenged the legitimacy of legislatures' reducing program spending. On the other side, representatives of regions and groups paying high taxes became increasingly militant over time in resisting further increases.

High-Debt Countries and Social Cohesion

Either by taxing or borrowing, finance ministries raise the money that line ministries spend. Earlier than most, participants in the "finance culture" of OECD countries recognized the growth of tax fatigue, signaled by the emergence of inefficient tax-avoidance behavior, and outright tax evasion. In most countries, the pragmatic short-term tactic since the 1970s to reconcile interest-group expectations was to resort to borrowing, accommodation of inflation, and optimistic projections of future economic growth and budget surpluses. This dynamic slowly eroded social cohesion in a number of OECD countries.

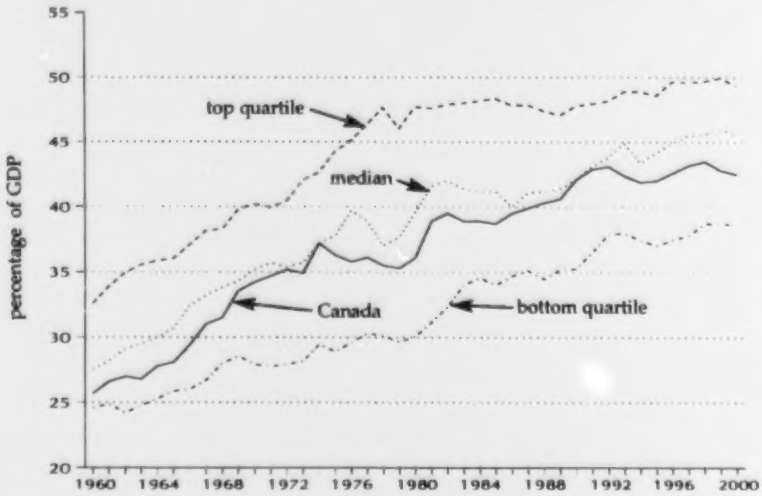
Canada

Canada was among the countries that, for many years, recorded deficits, experienced somewhat above-average inflation, and indulged in unrealistic revenue projections. As already mentioned, Canada's public sector was in continuous deficit from 1975 to 1996. And between 1982 and 1994, its deficit was continuously larger than the OECD median (except for 1988, when Canada was the median country).

There is an abundance of explanations for Canada's poor fiscal performance, and given the complexity of events, alternative explanations need not be mutually exclusive. At various times, the Bank of Canada pursued aggressive monetary restraint, raising short-term interest rates, which increased the deficit via several routes: reducing economic activity and hence tax revenues; increasing unemployment and the demand for social insurance benefits; and increasing the cost of servicing existing public debt.[8]

8 In 1990, a contentious incident took place: monetary restraint coincided with the onset of an international recession, generating a Canadian economic decline worse than average among OECD countries.

Figure 2: ***Government Revenues, 19 OECD Countries, 1960–2000***



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

Perhaps the most persuasive critic of the role played by the Bank of Canada has been Pierre Fortin (1996). Now even he allows the need to probe further: "Between 1975 and 1990, Canadian fiscal authorities forgot the prudent Keynesian principle of balancing the budget across business cycles" (1999, 36).

Why did fiscal authorities "forget" to balance the books? The answer is that politicians perceived no feasible political coalition willing to support the necessary fiscal decisions. Accordingly, the public sector consistently spent more than it taxed, becoming a constant source of macroeconomic stimulus. The central bank became, by default, the only guarantor of price stability.

A credible threat to a country's territorial integrity is a clear proxy that interest-group disagreements within that country are more severe than the norm. When major interests in particular regions threaten secession, it is an understatement to say that politicians have difficulty in exercising the discipline necessary to achieve fiscal balance. Reliance on deficits as a tactic to patch over social divisions is a strong temptation.

When major interests in particular regions threaten secession, it is an understatement to say that politicians have difficulty in exercising the discipline necessary to achieve fiscal balance.

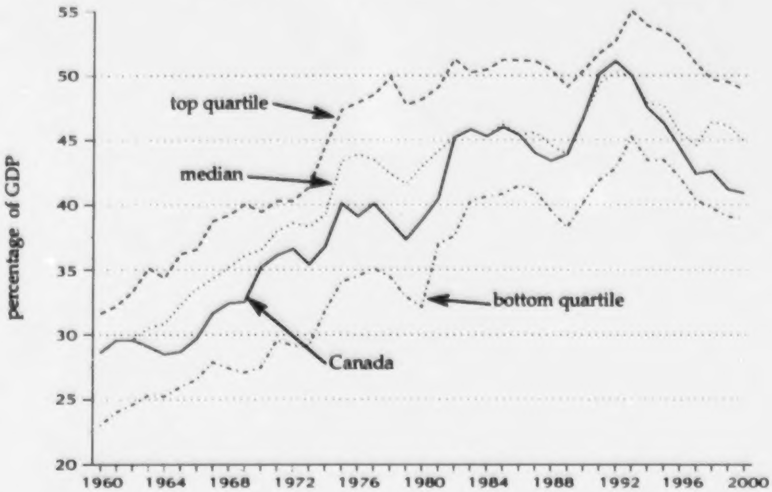
As an illustration of this argument, consider that the three OECD countries with the largest net public debt are, as already noted, Belgium, Italy, and Canada.

Belgium

Belgium came into existence in the nineteenth century, a time when religion mattered a great deal in determining group loyalties. Catholic Belgium wanted independence from the Protestant-dominated United Netherlands. That many Belgians spoke the same language as the Dutch was less important than the fact that virtually all Belgians shared religious beliefs.

Today, religion still matters in determining loyalties in many parts of the world (consider Islamic and Hindu revivalist movements, for example). But in most industrialized countries, language now matters more than religion in defining loyalties.

Figure 3: *Government Outlays, 19 OECD Countries, 1960–2000*



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

Political disagreements between French-speaking Walloons and Dutch-speaking Flemings have clearly become dysfunctional factors in the effectiveness of Belgian political institutions.

In addition, Belgian political conflict turns around Flemish resentment that the country's social policy entails large and seemingly permanent interregional redistribution from prosperous Flanders to relatively poor Wallonia, whose work force remains disproportionately employed in low-productivity heavy industry.

These problems have proved intractable over many decades. While the majority of Belgians want their country to survive intact, there is now widespread pessimism about the ability of the regional and linguistic communities to effect the required accommodations. To quote Judt, a prominent historian of Belgian ancestry:

> The price that has been paid to mollify the linguistic and regional separatists and federalists is high. In the first place, there is an economic cost; it is not by chance that Belgium has the highest ratio of public debt to gross domestic product in Western Europe. It is expensive to duplicate every service, every loan, every grant, every sign. (1999, 51.)

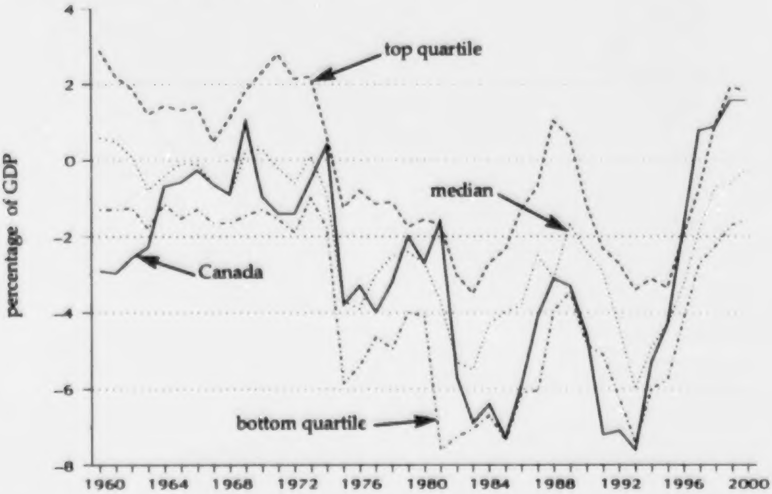
It is not by chance that Belgium has the highest ratio of public debt to gross domestic product in Western Europe.

Judt concludes on a downbeat mood:

> Swayed by political and economic forces beyond its control, caught between federalist decentralization and uncoordinated, incompetent government agencies without resources or respect, Belgium is the first advanced country truly at the mercy of globalization in all its forms. It is beginning to dawn on more than a few Belgians that in progressively dismantling and disabling the unitary state in order to buy off its internal critics, they may have made a Faustian bargain. (Ibid., 53.)

In other words, Judt, like many analysts, fears that central institutions are becoming a *coquille vide*.

Figure 4: ***Government Balances, 19 OECD Countries, 1960–2000***



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

Italy

Italy has no analogous religious or linguistic divisions. But, like Belgium, it has a weak central state and has existed as a political unit only since the mid-nineteenth century. Before unification, the Italian peninsula comprised a large number of political units, some externally controlled. Political cultures were divergent.

Why political cultures vary within Italy is the subject of a widely discussed study (Putnam et al. 1993). It attributes the source of economic success in the north to the high level of regional social capital, whereas the south has long been mired in a culture of low social capital, one symptom of which is political cronyism. So long as the Soviet empire remained intact and the Italian Communist Party was powerful, a plurality of northerners were prepared to ally themselves with southerners in a series of noncommunist coalition governments. At the core of these governments were generous programs of interregional income transfer whereby the north "bought" the loyalty of the south. Given the political culture of the *Mezzogiorno*, these transfers also rewarded inefficient political rent seeking, some of it manifestly criminal.

At the core of these [Italian] governments were generous programs of interregional income transfer whereby the north "bought" the loyalty of the south.

With the fall of the Berlin Wall and the collapse of the communist threat, many northern Italians rejected the economic terms of their former coalition with southerners. In the mid-1990s, separation of the north became a lively political issue.

All this makes it perfectly understandable why Italians, particularly northern Italians, are among the most enthusiastic supporters of the euro. A precondition for any country's adopting the euro is that its government accept fiscal constraints on the size of debt and deficits. In effect, northern Italians and Flemish Belgians are relying on the EU to impose the fiscal discipline that domestic interest groups have historically been unable to realize among themselves.[9]

9 An elegant elaboration of this thesis is to be found in an address by Judge Mancini (2000), published posthumously in *Foreign Affairs*. Until his death, Mancini was the Italian representative on the European Court of Justice.

Some Similarities

What goes on in countries is complicated, and there are dangers in proposing significant similarities across them. Nonetheless, in assessing these three high-debt countries, two similarities irresistibly stand out.

Language Matters

Language conflicts have loomed large in both Canada and Belgium over the past generation. Belgians base their language policy almost exclusively on territory, an approach that encourages intralinguistic and not interlinguistic interaction. Overall, this has hampered the country's ability to effect stable compromises along diverse dimensions of public life, including the fiscal dimension.

While the emphasis on territory need not be as absolute as in Belgium, a significant territorial bias is clearly necessary for countries that are intent on preserving their multilingual status intergenerationally. Successive generations will choose to speak a language only if a stable community speaks it. In turn, for that stability to exist, public policy must unambiguously favor the public use of one language over others in the relevant regions of the country. Linguistic communities simply do not survive without a core territory that they can protect against competitors. These propositions apply to all multilingual countries — from Belgium, to Switzerland, to India, and to Canada.

Linguistic communities simply do not survive without a core territory that they can protect against competitors.

The great majority of francophone Quebecers believe linguistic protection is necessary if French is to remain the dominant language spoken in the province.[10] Rising rates of linguistic assimilation among francophones outside Quebec provide ample support for this conviction (Charles Castonguay 1999). Not surprisingly, francophone Quebecers strongly endorse the principle of restricting English public services in Quebec and consider Bill 101 a reasonable compromise between protection for French and the linguistic minority's expectation of services in English. In francophone Quebec, the Charte de la langue française enjoys a legitimacy comparable to that of the Charter of Rights and Freedoms elsewhere in the country.

In contrast, Ottawa's language policies lie at the other extreme of Belgium's. They define language policy as free individual choice between two official languages and ignore territorial bases. The Charter of Rights and Freedoms, for example, poses language policy in terms of minority rights to be protected; it is resolutely silent on the

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10 Approximately two-thirds of francophone Quebecers are concerned about the survival of French within the province, a statistic that has been constant over two decades of polling. And at least a third of francophone Quebecers believe that the status of French would be more secure if the province were sovereign. See Pinard et al. (1997) for an exhaustive survey of public polling data on this subject.

In his recently published book, which makes the case for the Parti Québécois to redefine its strategy, Jean-François Lisée documents the stability of Quebec attitudes on the subject of linguistic protection. For this book, Lisée commissioned a poll bearing on powers that, in his opinion, Quebec needs if it is to remain a province within Canada. One question in the poll, conducted in late 1999, was the following: "At the moment, the Quebec government enjoys a limited autonomy with respect to language laws. These laws are constrained by the Canadian government and the Canadian constitution. Do you think the Quebec government should have complete control over budgets and decisions concerning language use in Quebec?" (2000, 388; my translation). Among francophone Quebecers, 72 percent responded yes, 24 percent said no. Among nonfrancophones, the results were roughly reversed: 26 percent said yes, 72 percent no. (The remainder in each group was undecided.)

matter of linguistic protection for the Quebec francophone majority. Predictably, anglophones in Quebec and francophones elsewhere endorse the Charter.

In other words, groups representing Canadian language communities have — to understate matters — pursued noncooperative strategies.[11] Quebec sovereigntists consider the threat of linguistic assimilation a reason for secession.[12] On the other side of the linguistic divide, many who champion Ottawa's language policies — the official-language minorities prominent among them — portray Quebec's language laws as exercises in intolerant discrimination against the English-speaking minority. By insisting that language policy be defined in terms of minority language rights to be litigated, Ottawa has provided a textbook illustration of the destructive potential of what Fukuyama describes as "rights culture."

By insisting that language policy be defined in terms of minority language rights to be litigated, Ottawa has provided a textbook illustration of the destructive potential of what Fukuyama describes as "rights culture."

Many prominent analysts insist that Ottawa's rights-based approach to language policy is an underlying variable explaining the Quebec problem. Burelle (1995) identifies this as one dimension of *le mal canadien*. McRoberts (1997) concludes that Ottawa's version of official bilingualism is "misconceiving Canada." Laforest (1998) co-edited a widely discussed book, appropriately entitled *Beyond the Impasse*. And Claude Castonguay writes:

> The [present political] situation continues to be blocked. On one side we have the militant nationalists who, without success, try by various means to persuade a majority of Quebecers of the need for independence. On the other side we have, since Pierre Trudeau, federalists who refuse to recognize clearly the nature of Quebec's distinctness. The majority of Quebecers place themselves between these two poles. This confrontation between *indépendantistes* and *soi-disant fédéralistes* is terribly sterile, damaging and frustrating. More and more, it resembles the 1950s, a decade characterized by stagnation and the refusal to open up Quebec society. (1999, B3.)

Interregional Transfers Have Effects

Since the 1960s, Ottawa has maintained three major intergovernmental transfer programs: equalization, Established Programs Financing (EPF), and the Canada Assistance Plan (CAP).[13] With a few exceptions, these transfers provided more than a third of the revenues of the six smallest provincial governments from the mid-1980s to the mid-1990s (see Figure 5). In addition, Ottawa redesigned unemployment insurance in the early 1970s in a manner that assured permanent interregional redistribution from the five provinces west of Ottawa to the five east of it.[14] As recently as fiscal year

11 See Johnston and Soroka (1999) for a discussion of social capital measures across Canadian regions and ethnic groups. The study disaggregates and reports results along several dimensions. In terms of trust in the "Canadian political system," Quebecers score relatively high. It is unclear whether this measure reflects trust in their provincial government, in the federal nature of the country or in central institutions. Not surprisingly, as measured, Quebecers display statistically significant less-than-average "national pride" in being Canadian.

12 See Dumont (1997) for an eloquent statement of the argument.

13 In 1996, the second and third were combined into the Canada Health and Social Transfer — CHST.

14 Because Quebec has opted out of various federal programs over the past decades, the province enjoys unique tax-abatement provisions, whereby Ottawa lowers its transfers to the province and simultaneously lowers income tax rates on residents of the province. Including the value of tax abatements as a component of transfers increases federal transfers to the province by approximately 5 percentage points.

1994/95, these four programs comprised over a third of federal program spending (Canada 1995, 85).

Never stated explicitly but well understood by all senior administrators and cabinet ministers in Ottawa, a *de facto* rationale for the magnitude of these programs was to gain short-term support for the political status quo in net recipient regions, given that noncooperative interest-group strategies prevented resolution of underlying problems.

"Buying" support for federalism in Quebec is the most important instance of this dynamic. Unable to resolve the cultural and linguistic conflicts animating the sovereigntist movement, federal politicians have supplied money. The disproportionate distribution to Quebec of numerous discretionary grants is an example. Even since the 1995 program spending cuts, Ottawa continues to transfer significant amounts to Quebec. By Boothe's estimates, in fiscal year 1996/97 Quebec received nearly half the net benefit arising from the major programs providing interregional redistribution.[15]

In the Atlantic provinces, coalitions involving all sectors of society, including business, have opposed out-migration as a strategy for resolving the region's low average productivity.

Quebec has not been the only beneficiary. Indeed, Atlantic Canada received nearly twice as much per capita under these programs. In the Atlantic provinces, coalitions involving all sectors of society, including business, have opposed outmigration as a strategy for resolving the region's low average productivity. Ottawa has "bought off" Atlantic interest groups by incorporating regional redistribution into many programs (in addition to the major programs evaluated by Boothe).

The Atlantic cod fishery is an example of the economic tragedy arising from politicians' decades-long inability to link aid to outmigration. Ottawa acquiesced to regional interests desirous of maintaining employment in the fishery and neglected its responsibilities as steward of the stocks. The Department of Fisheries and Oceans set biologically unsustainable harvesting quotas, and the Department of Human Resources Development subsidized the labor and capital engaged in an unsustainable fishing effort. The result has been the near-extinction of groundfish stocks on the Grand Banks (see Harris 1998).

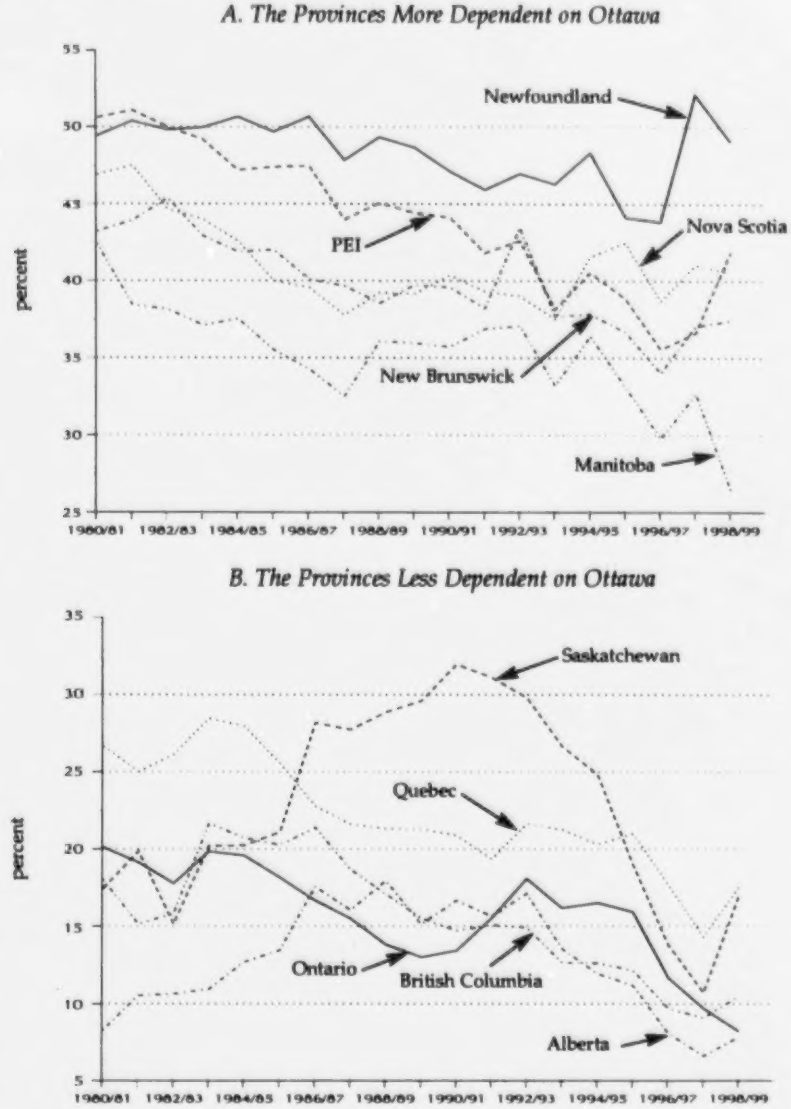
The inappropriate conclusion to draw here is that Ottawa should refrain from all interregional redistribution. Some such programs make good sense. Having complex social programs designed and administered by provincial governments, rather than by Ottawa, is almost certainly efficient in a country of continental dimensions. The federal government contributes to realizing the efficiencies of social program decentralization by using the relative stability of its revenues to fund equalization, an intergovernmental insurance system that provides all provinces, in the words of the *Constitution Act, 1982*, with "reasonably comparable levels of public services at reasonably comparable levels of taxation" (section 36(2)).[16] Equalization, however, comprises only a small part of Ottawa's interregional redistribution.

The appropriate conclusion to draw is that sublimating the political problems of Quebec nationalism and low regional productivity by means of large interregional transfers has not been a solution; the transfers have become part of the country's fiscal problem.

15 In calculating the net redistribution from equalization, the CHST, and the regional component of EI, Boothe subtracts from the gross transfer to any province its share of total federal revenue receipts. On a net basis, Quebec received $4.1 billion of the total of $8.8 billion redistributed via these programs (1998, 48).

16 This is part of the efficiency case for the existence of equalization. For an accessible recent review of debates surrounding equalization, see Boothe (1998).

Figure 5: *Federal Cash Transfers as a Share of Total Provincial Revenues, fiscal years 1980/81 to 1998/99*



Source: Author's calculations from Canada 1999a.

In the short run, these transfers have secured regional acquiescence to the status quo. In the longer run, however, they have contributed to protracted deficits and destroyed the ability of the two major political parties to sustain transcontinental coalitions. In western Canada and much of Ontario, the majority of voters have become convinced that federal transfers unduly retard productivity-enhancing reallocations of people and capital, that they provide an undue fiscal benefit to Quebec, and that the financing of these transfers requires inefficient levels of federal taxation. A plurality of western Canadians have for the past decade supported the Reform Party, one of whose fundamental goals is to reduce interregional redistribution. And notwithstanding

Ottawa's fiscal generosity, the majority of francophone Quebecers remain severely dissatisfied with the federal status quo.[17]

Who Did What, When, and Why?

Bad things happen to good governments. The recessions of the early 1980s and early 1990s engendered four episodes of serious deficit (defined as more than 6 percent of GDP) in a trio of Scandinavian countries. The cooperative political culture in those countries enabled these governments to address their fiscal problems in a timely way and limit the duration of deficits. The maximum period of continuous deficit across these four episodes was eight years (see Figure 6, panel A).

Contrast this trio with Belgium, Italy, and Canada, which fell into serious deficit over the 1972–82 period and did not mount credible campaigns to end their respective deficits until the mid-1990s (Figure 6, panel B). The external constraint of the Maastricht Treaty enabled Belgian and Italian politicians to end fiscal profligacy. Canada had no analogous external constraint obliging it to mend its ways.

How did Canada achieve fiscal redress? This question is an important one. Before we draw conclusions, we need to review briefly the country's recent fiscal history.

Figure 7 illustrates the trajectories of the budgetary balances of Ottawa and the ten provinces over the past decade. Early in the decade, deficits were generally less severe than average in Atlantic Canada, Manitoba, and British Columbia; near average in Quebec; and more severe than average in Ontario, Saskatchewan, Alberta, and Ottawa. If fiscal year 1991/92 is used as benchmark, Ottawa accounted for three-fifths of the aggregate federal-provincial deficit; the provinces collectively accounted for two-fifths (as we shall see below).

If fiscal year 1991/92 is used as benchmark, Ottawa accounted for three-fifths of the aggregate federal-provincial deficit; the provinces for two-fifths

The Options Available

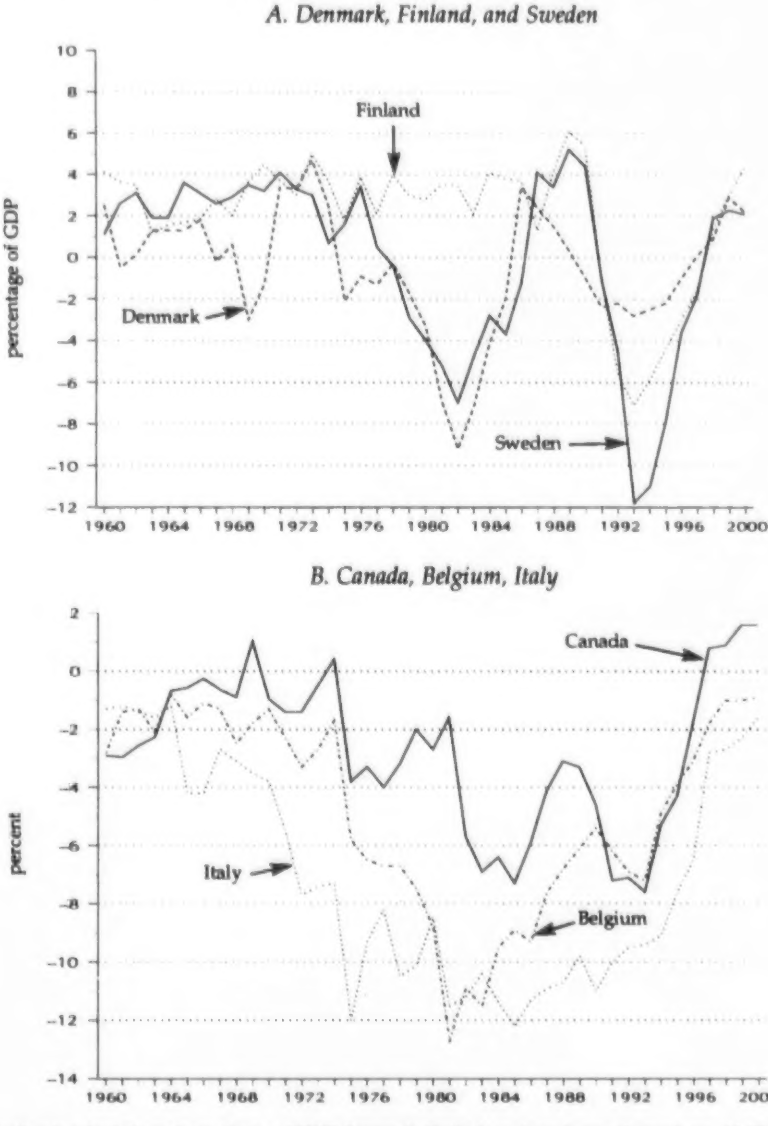
Over the course of the 1990s, all senior governments made progress in balancing their respective accounts. In the short run, they could do little about rising debt-service costs, which were a legacy from past budgeting decisions. To redress their accounts, they could either increase revenues or reduce program spending. (In the tables that follow, the results of these actions are labeled "own initiatives" and calculated as the sum of a government's own-source-revenue increases plus its program spending reductions — or less its program spending increases.)

17 In a Léger & Léger poll, conducted in February 2000, Quebecers were asked, "Which of the following options is the closest to your opinion?" Of the three options presented, "maintaining the status quo" was chosen by 18 percent, "sovereignty-association" by 30 percent, and "renewal of the federation with more powers [for the province]" by 41 percent. The breakdown by linguistic community was:

	Francophones	Nonfrancophones
	(percent)	
Status quo	16	28
Sovereignty-association	34	1
Renewal of the federation	40	47

The choices of the remaining 11 percent are not indicated in the source (Mackie 2000); presumably, they were undecided or gave no answer.

Figure 6: ***Government Balances, Selected Countries, 1960–2000***



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

Ottawa had no alternative to taking those "own initiatives"; the provinces, however, had a third option available. Federal transfer programs are based on prearranged formulas, but actual transfers are a good deal less predictable than such a statement implies. The provinces consistently lobby Ottawa to increase cash transfers or to be excused from transfer cuts that would otherwise take place. They can also increase spending on shared-cost programs that induce an increase in transfers.[18] It has

18 The potential of a province to induce federal transfers by spending on shared-cost programs was much reduced when the major shared-cost program, the CAP, was terminated in 1996. However, a provincial government can induce transfers to individuals by offering short-term employment with the expectation that workers, once their employment is terminated, will receive EI benefits and spend them within the province.

always been open to Ottawa to exercise discretion in interpreting regulations and, *in extremis*, to rewrite the formulas, as it did in capping CAP payments in 1990; in the 1995 federal budget, which simultaneously created the CHST and reduced transfers under it;[19] and in the 1999 and 2000 budgets, which significantly increased CHST transfers.

Relative to fiscal year 1991/92, all senior governments had increased revenue by 1998/99. The only two to reduce program spending during the seven-year interval were Ottawa and Alberta.

Relative to fiscal year 1991/92, all senior governments had increased revenue by 1998/99 (Table 2, column 1). The only two to reduce program spending during the seven-year interval were Ottawa and Alberta (column 2).[20] For all jurisdictions except Prince Edward Island, the value of "own initiatives" (column 3) was positive over the seven years.

The changes in federal transfers to the provinces (column 4) arose in the first instance from application of the relevant formulas for equalization and other intergovernmental transfers. Whatever the relative weight attributable to changes in exogenous variables determining equalization, to straightforward application of the transfer formulas, to Ottawa's redesign of the formulas, to lobbying by particular governments, and to other *ad hoc* explanations,[21] the provinces experienced divergent fortunes in terms of cash transfers over the seven years under review. Quebec and the Atlantic provinces experienced increases; the remaining five, decreases. Relative to aggregate improvement in respective operating balances, the Prairies experienced the largest transfer declines, followed by Ontario and British Columbia.

The aggregate change in operating balances (column 5) is the sum of own initiatives plus changes in federal transfers. Adding changes in debt-service costs (column 6) yields the changes in budgetary balances (column 7).

Table 3 shows the relative contribution of the three options to improve operating balances. In Ottawa's case, revenue increases accounted for nearly 90 percent of the $37.5 billion rise realized from fiscal year 1991/92 to 1998/99; cuts to program spending contributed 10 percent. To take a provincial example, own-source revenue increases accounted to 38 percent of Newfoundland's $371 million improvement in its operating balance, but increased program spending equivalent to 26 percent of the total improvement offset the revenue increase, generating a total for "own initiatives" of 12 percent. Increased federal transfers accounted for the remaining 88 percent.

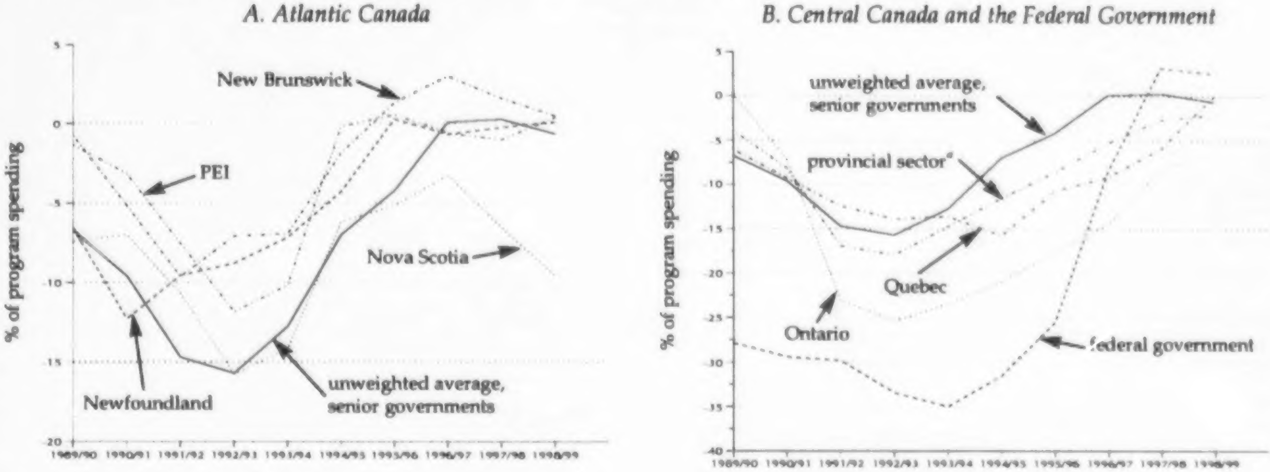
Overall in Atlantic Canada, "own initiatives" amounted to slightly more than a quarter of the improvement in operating balances; increased federal transfers to nearly three-quarters. In Quebec, "own initiatives" were about five-sixths of the total, and

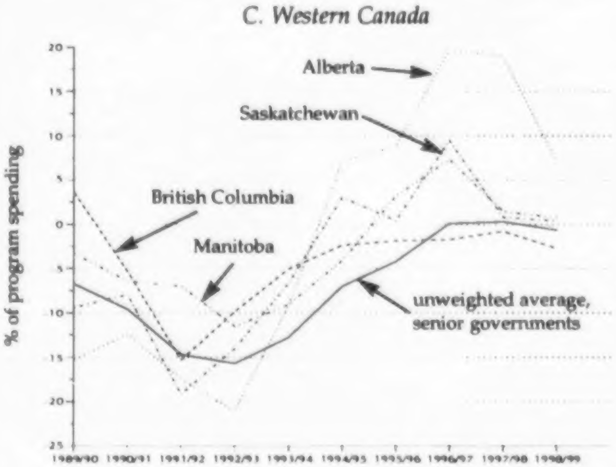
19 It has been argued that transfer cuts amount to deficit offloading and are a federal counterpart to provincial lobbying for transfer increases. Whether reducing transfers was a wise policy choice is open to debate. Personally, I think it desirable (Richards 1997, 76–77). Regardless of conclusions as to the wisdom of the transfer cuts, there is a political asymmetry between Ottawa's reducing transfers and provinces' lobbying for transfer increases. Whenever Ottawa reduces transfers or any other program, it adversely affects powerful interest groups that can, directly via federal channels or indirectly via provincial channels, adversely affect the fortunes of the government in power. No such immediate sanction exists for provincial lobbying. Most of the tax cost of any increase in transfers is borne by taxpayers beyond the lobbying province.

20 The figures in the table are in nominal dollars, and are not normalized for population changes. In real per capita terms, most jurisdictions did reduce spending after 1991/92. For further explanation of the accounting conventions lying behind these time series, see the discussion in the Appendix.

21 For example, in its 1999 budget, Ottawa designated a CHST supplement that the provinces could draw over three years to finance health care programming. Ottawa allowed the provinces discretion in the timing of their draws. Certain provinces applied large draws to their fiscal year 1998/99 budgets.

Figure 7: *Budgetary Balances of Canadian Governments, fiscal years 1989/90 to 1998/99*





Note: Balances are on a public accounts basis. Results are normalized relative to program spending in each jurisdiction in each year. The average among the 11 senior governments is the average percentage cut (in the case of a deficit) in program spending that would have been required, all else unchanged, in the typical jurisdiction to realize a zero balance in the relevant year.

[a] The aggregate budgetary balance of the ten provinces.

Source: Author's calculations from Canada 1999a.

increased transfers one-sixth. Further west, cash transfers declined; hence, "own initiatives" were larger than the aggregate improvement in operating balances.

The composition of "own initiatives" differed substantially across regions. British Columbia stands out as the region that most dramatically increased its own-source revenues relative to its change in operating balances. In all regions, program spending increases offset, to a greater or lesser extent, the fiscal improvement arising from higher revenues. This offset was most pronounced in British Columbia, least pronounced in Ontario and the Prairies.

Index of "Own Initiatives" to "Own Deficit"

Table 4 shows the federal-provincial deficit and its distribution in the reference fiscal year 1991/92 (columns 1 and 2). The table also displays the value of "own initiatives" and their distribution. (columns 3 and 4). The initiatives/deficit index (column 5) refers to the share of "own initiatives" relative to the share of deficit in the reference year. An index value of 1.00 means that the jurisdiction or region undertook "own initiatives" since 1991/92 proportionate to its share of the federal-provincial deficit that year. An index value above 1.00 means that it did more than its share; below 1.00, that it did less.

Ottawa achieves an index value of 0.93. It accounted for 56 percent of "own initiatives," somewhat less than its 60 percent share of the 1991/92 deficit. Quebec, Ontario, and British Columbia achieved index values between 0.79 and 1.13. At the provincial level, the outliers are Prince Edward Island, with a negative index value (its

Table 2: *Changes in Fiscal Aggregates, fiscal years 1991/92 to 1998/99*

	Own-Source Revenues (1)	Program Spending (2)	Own Initiatives[a] (3)	Federal Cash Transfers (4)	Operating Balance (3 + 4) (5)	Debt-Service and Other Costs (6)	Budgetary Balance (5 – 6) (7)
				(millions of dollars)			
Federal government	33,639	– 3,822	37,461		37,461	220	37,241
Provinces	39,330	9,789	29,541	– 1,171	28,370	8,652	19,718
Total	72,969	5,967	67,002	– 1,171	65,831	8,872	56,959
By province							
Newfoundland	141	98	43	328	371	91	280
Nova Scotia	234	207	27	242	269	247	22
Prince Edward Island	80	86	– 6	58	52	– 1	53
New Brunswick	494	234	260	249	509	92	417
Quebec	9,545	3,888	5,657	1,236	6,893	2,592	4,301
Ontario	15,922	1,461	14,361	– 1,816	12,645	4,876	7,769
Manitoba	1,242	584	658	– 261	397	23	374
Saskatchewan	1,872	453	1,419	– 314	1,105	245	860
Alberta	4,068	– 603	4,671	– 815	3,856	201	3,655
British Columbia	5,732	3,381	2,351	– 78	2,273	286	1,987
By region							
Atlantic provinces	949	625	324	877	1,201	429	772
Quebec	9,545	3,888	5,657	1,236	6,893	2,592	4,301
Ontario	15,922	1,461	14,361	– 1,816	12,645	4,876	7,769
Prairie provinces	7,182	434	6,748	– 1,390	5,358	469	4,889
British Columbia	5,732	3,381	2,351	– 78	2,273	286	1,987

[a] "Own initiatives" are the sum of a government's own-source-revenue increases plus its program spending reductions — or less its program spending increases.

Source: Author's calculations from Canada 1999a.

"own initiatives" were negative), and Manitoba, with an index value of 1.68. On a regional basis, the outliers are Atlantic Canada, with an index value of 0.25, and the Prairie provinces, with an index value of 1.51.

Conclusions

With the evidence laid out in some detail, it is time to draw some conclusions.

The Role of the Provinces

The provinces are as important as Ottawa to the country's overall fiscal health.

The first conclusion is simply that, in aggregate, the provinces have mattered nearly as much as Ottawa in terms of both contributing to deficits early in the 1990s and restoring fiscal balances in subsequent years. As the economy entered recession in 1990, the provinces initially increased their spending, and the provincial sector plunged into serious deficit. In the reference fiscal year 1991/92, they contributed 40 percent of the

Table 3: *Changes in Operating Balances, fiscal years 1991/92 to 1998/99*

	Relative Contribution of				
	Increase in Own-Source Revenues (1)	Decrease in Program Spending (2)	Own Initiatives[a] (1 + 2) (3)	Increase in Federal Cash Transfers (4)	Total (3 + 4) (5)
			(percent)		
Federal government	89.8	10.2	100.0		100.0
Provinces	138.6	- 34.5	104.1	- 4.1	100.0
Total	110.8	- 9.1	101.8	- 1.8	100.0
By province					
Newfoundland	38.0	- 26.4	11.6	88.4	100.0
Nova Scotia	87.0	- 77.0	10.0	90.0	100.0
Prince Edward Island	153.8	- 165.4	- 11.5	111.5	100.0
New Brunswick	97.1	- 46.0	51.1	48.9	100.0
Quebec	138.5	- 56.4	82.1	17.9	100.0
Ontario	125.9	- 11.6	114.4	- 14.4	100.0
Manitoba	312.8	- 147.1	165.7	- 65.7	100.0
Saskatchewan	169.4	- 41.0	128.4	- 28.4	100.0
Alberta	105.5	15.6	121.1	- 21.1	100.0
British Columbia	252.2	- 148.7	103.4	- 3.4	100.0
By region					
Atlantic provinces	79.0	- 52.0	27.0	73.0	100.0
Quebec	138.5	- 56.4	82.1	17.9	100.0
Ontario	125.9	- 11.6	114.4	- 14.4	100.0
Prairie provinces	134.0	- 8.1	125.9	- 25.9	100.0
British Columbia	252.2	- 148.7	103.4	- 3.4	100.0

[a] "Own initiatives" are the sum of a government's own-source-revenue increases plus its program spending reductions — or less its program spending increases.

Source: Author's calculations from Canada 1999a.

combined federal-provincial deficit. Between 1991/92 and 1998/99, their contribution to the restoration of fiscal health amounted to 44 percent of aggregate federal-provincial "own initiatives."

In the early 1990s, conventional wisdom among many senior bankers and officials in the finance ministries of the 11 capitals was that no political coalition would be able to effect fiscal redress without the catalyst of one or more senior governments' hitting the debt wall (finding themselves unable to sell bonds). This elite conventional wisdom entertained a range of pessimistic scenarios, which included the effective bankruptcy of the most indebted provinces as Ottawa took them into trusteeship and a massive selloff of Canadian debt (as later occurred in Mexico).

Several provinces did skirt the wall in that institutional lenders issued dire warnings, but none hit it. Instead, the 11 senior governments collectively restored public finances to a reasonable — if still fragile — state of health. The various panels of Figures 8, 9, and 10 trace, by means of indexes, how each jurisdiction's own-source revenues, program expenditures, and federal transfers changed in the course of this collective political endeavor.

Table 4: *Distribution of Budget Balances, fiscal year 1991/92, and of Own Initiatives, fiscal years 1991/92 to 1998/99*

	Budget Balances, 1991/92		Own Initiatives,[a] 1991/92 to 1998/99		Own Initiative[a]/ Own Deficit
	(1)	(2)	(3)	(4)	(5)
	($ millions)	*(percent)*	*($ millions)*	*(percent)*	*(index)*
Federal government	−34,357	60.26	37,461	55.91	0.93
Provinces	−22,654	39.74	29,541	44.09	1.11
Total	−57,011	100.00	67,002	100.00	1.00
By province					
Newfoundland	−276	0.48	43	0.06	0.13
Nova Scotia	−406	0.71	27	0.04	0.06
Prince Edward Island	−50	0.09	−6	−0.01	−0.10
New Brunswick	−355	0.62	260	0.39	0.62
Quebec	−4,301	7.54	5,657	8.44	1.12
Ontario	−10,930	19.17	14,461	21.58	1.13
Manitoba	−334	0.59	658	0.98	1.68
Saskatchewan	−842	1.48	1,419	2.12	1.43
Alberta	−2,629	4.61	4,671	6.97	1.51
British Columbia	−2,531	4.44	2,351	3.51	0.79
By region					
Atlantic provinces	−1,087	1.91	324	0.48	0.25
Quebec	−4,301	7.54	5,657	8.44	1.12
Ontario	−10,930	19.17	14,461	21.58	1.13
Prairie provinces	−3,805	6.67	6,748	10.07	1.51
British Columbia	−2,531	4.44	2,351	3.51	0.79

[a] "Own initiatives" are the sum of a government's own-source-revenue increases plus its program spending reductions — or less its program spending increases.

Source: Author's calculations from Canada 1999a.

The Beginning of Fiscal Redress

Fiscal redress in the 1990s began on the Prairies.

In understanding who did what in restoring Canada's fiscal balances in the 1990s, the point of departure lies not in Ottawa with Finance Minister Paul Martin's fiscal year 1995/96 budget but in the Prairie provinces three years earlier. Saskatchewan began its fiscal ascent in 1992/93, and Alberta the following year. By the time Martin delivered his seminal budget address in spring 1995, these two provinces and the region in aggregate had already achieved fiscal surplus. Manitoba realized a surplus by 1995/96 (see Figure 7, panel C). Relative to the reference year 1991/92, the Prairies also accommodated the proportionately largest regional cuts in intergovernmental transfers (see Figure 10).

Why did the Prairies act first? There is no single explanation. Economic recovery in the Prairie farm economy would have increased own-source revenues somewhat, even without the discretionary tax increases that provincial governments imposed. Random events probably also mattered. In Edmonton and Regina new premiers came into office,

and both made the strategic decision to balance their budgets within their legislative mandates.

The foundation on which these events transpired was a culture of regional political cooperation. Without this culture would the region have elected leaders committed to balanced budgets? Probably not. Without this culture, would these premiers have faced opposition similar to that of Nova Scotia Premier John Savage, an unsuccessful champion of fiscal redress? Quite likely.

Programs of fiscal redress undertaken by Prairie governments were initially controversial, but more so outside the region than locally. The local majority perceived them to be necessary, and leaders of most local interest groups accepted that the fiscal pain was being applied with reasonable equity and respect for preserving core public services. Despite fiscal restraint — it might be more accurate to say because of fiscal restraint — Prairie voters re-elected their respective provincial governments in elections conducted in 1995 and 1996.

Of the 11 senior governments, Alberta and Saskatchewan conducted exercises in fiscal redress that were among the most arduous in revenue increases, program cuts, and duration.

Of the 11 senior governments, Alberta and Saskatchewan conducted exercises in fiscal redress that were among the most arduous in revenue increases, program cuts, and duration. These two provinces demonstrated that local majorities can be persuaded to endorse the sustained political effort required to restore fiscal well being. They differed in the relative weight they placed on spending cuts and tax increases, but the differences were more of degree than of kind. Inasmuch as per capita program spending was higher in Alberta than Saskatchewan, the former not surprisingly relied more on spending cuts, the latter on revenue increases. Both undertook three years of continuous program spending cuts. These resulted in a peak-to-trough reduction of 10 percent in Saskatchewan (fiscal years 1990/91 to 1993/94) and 21 percent in Alberta (1992/93 to 1995/96). Measuring from their revenue troughs (which occurred for both in 1991/92) to 1994/95 (the year both achieved balanced budgets), Saskatchewan increased its own-source revenues by 41 percent, and Alberta by 23 percent.

In 1993/94, Manitoba began its more sedate ascent to a positive fiscal balance. Having a smaller deficit, it held program spending constant and relied on increases in own-source revenues, which had hit a trough in 1992/93. By the time the province achieved a positive balance in 1995/96, it had increased own-source revenues by a quarter.

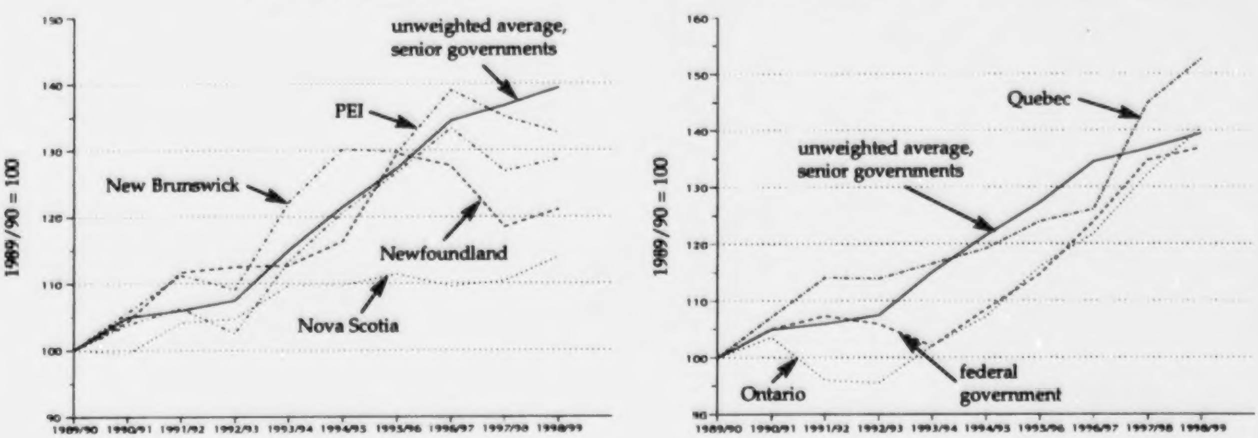
Another measure of these Prairie initiatives is provided by Table 5, which shows the ratio of taxpayer-supported provincial debt to GDP in the ten provinces. At the end of the benchmark fiscal year 1991/92, Saskatchewan, Alberta, and Manitoba ranked, respectively, first, sixth, and seventh by that ratio. Seven years later, the severity of debt had declined in all three; their respective rankings had fallen to sixth, tenth, and eighth.

By all accounts, the fiscally and politically successful Prairie experience — of Ralph Klein's Alberta Conservatives in particular — influenced the Ontario Conservatives' "common sense revolution." Although harder to document, the demonstration effect was probably important in persuading politicians in Ottawa and other capitals that they could potentially maintain political support over the course of a sustained exercise in fiscal redress.

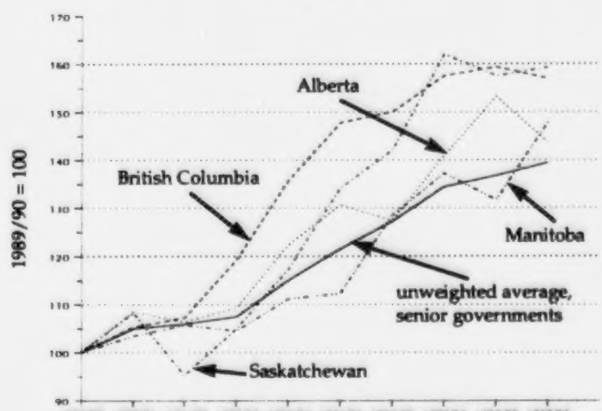
Overall, the fiscal and political history of the Prairies illustrates the importance of a measure of political cooperation at the regional level if Canadian federalism is to function effectively. The essence of federalism is a constitutional division of powers — of both spending powers and taxing powers — across two or more orders of

Figure 8: *Own-Source Revenues of Canadian Governments, fiscal years 1989/90 to 1998/99*

A. Atlantic Canada *B. Central Canada and the Federal Government*



C. Western Canada



Source: Author's calculations from Canada 1999a.

government. Implicit in the federal ideal is tax and spending coincidence: that citizens and interest groups within a subnational state, oblast, canton, or province are empowered to decide freely the nature of locally supplied goods and services but, subject to revenue-sharing agreements with the central order of government, must tax themselves accordingly.

A formal federal constitution does not mean, however, that politicians and interest groups will obey the rules. To take two extreme examples, Russia and India have federal constitutions, but much of the entrepreneurial energy of regional political leaders in both countries is devoted to fiscal lobbying in the national capital. Genuine federalism requires a reasonably robust level of social cooperation within the regions. Without it, regional political agents cannot undertake the political calculus of equating incremental tax costs and the incremental social benefits arising from provision of local public services.

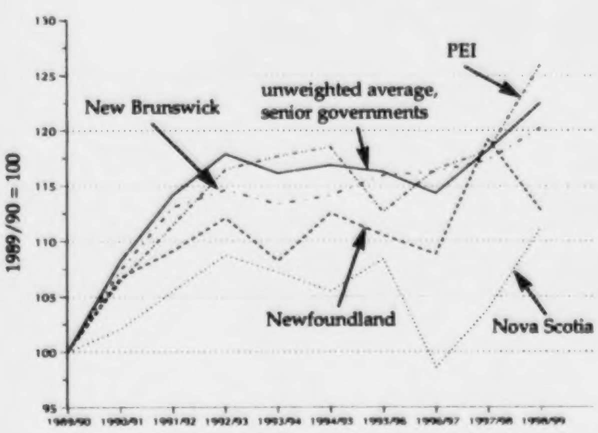
Well-functioning federations require a political culture that rewards local politicians according to how well they undertake this political calculus. Emphatically, efficient functioning requires that the political culture not reward local politicians primarily for their success in rent seeking in the national capital.

Admittedly, in the Prairies as elsewhere, the reality falls short of the ideal. The post–1997 agricultural recession provided an adverse economic shock. Net cash income among Prairie farmers in 1998 was about 15 percent lower than the 1994–97 average. The decline was most severe in Saskatchewan, somewhat less in the two other provinces.[22] In turn, the decline induced a burst of Prairie political lobbying in Ottawa

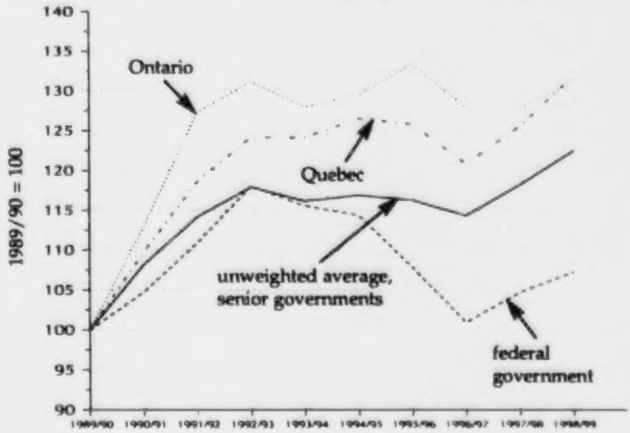
22 The net cash income data here are derived from unpublished reports of the federal Department of Agriculture.

Figure 9: *Program Expenditures of Canadian Governments, fiscal years 1989/90 to 1998/99*

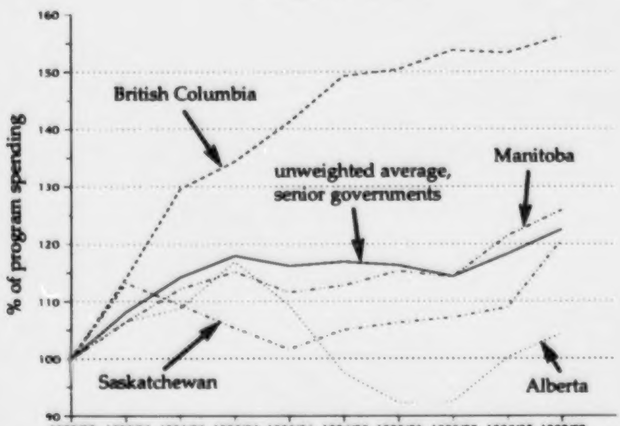
A. Atlantic Canada



B. Central Canada and the Federal Government



C. Western Canada



Source: Author's calculations from Canada 1999a.

for *ad hoc* transfers. Nevertheless, the Prairie provinces have retained budget surpluses, not without difficulty in the case of the two smaller provinces.

The Dangers of Rent Seeking

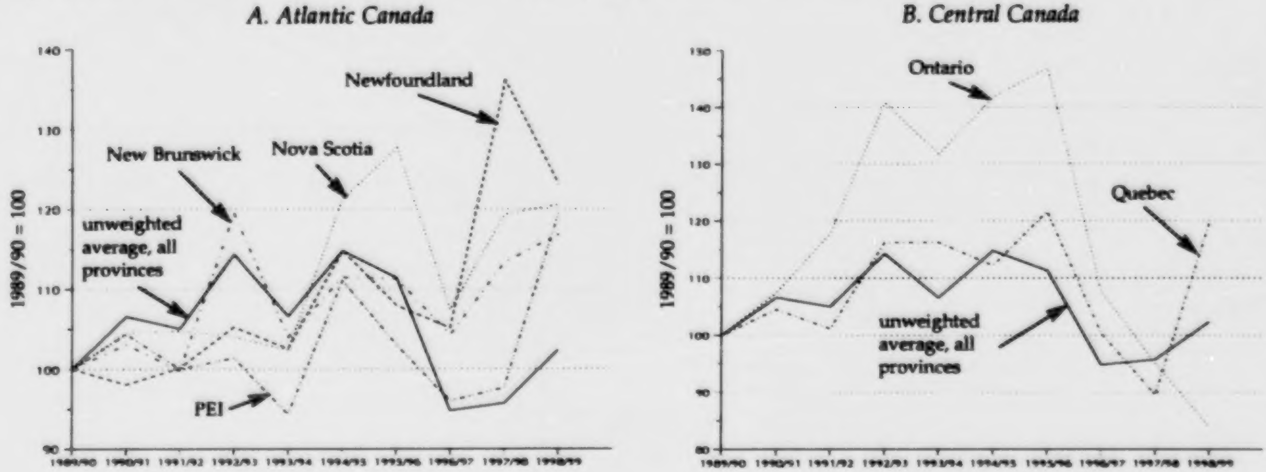
The culture of federal-provincial rent seeking in Atlantic Canada weakened the region's ability to pursue fiscal redress.

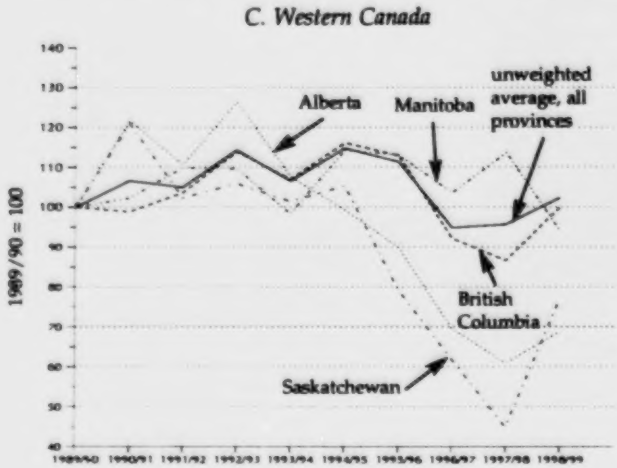
With an index value of 0.25, the Atlantic provinces' cumulative share of "own initiatives" was only a quarter of their share of the combined federal-provincial deficit in the reference fiscal year, 1991/92. Relative to Ottawa and the other regions, Atlantic Canada is an outlier. Like the other provinces, the Atlantic provinces have improved their operating balances since 1991/92, but nearly three-quarters of the aggregate improvement has been attributable not to "own initiatives" but to an increase of nearly $900 million in annual federal transfers.

In government budgeting, Atlantic Canada generally demonstrates more similarities with Wallonia and southern Italy than with the Prairies. Many Atlantic Canadians do not believe that regional politicians should design provincial services within the budgetary constraint imposed by own-source provincial revenues, with federal transfers being a minor supplement. They perceive equalization, for example, not as an intergovernmental revenue insurance program against adverse short-term fiscal events but as one of several permanent transfers.

Admittedly, regional interest groups across the country lobby to maximize Ottawa's transfers to their area. In Atlantic Canada, however, intergovernmental transfers consistently loom larger than elsewhere (recall Figure 5), and regional voters frequently

Figure 10: *Federal Cash Transfers to the Provinces, fiscal years 1989/90 to 1998/99*





Source: Author's calculations from Canada 1999a.

elect politicians, both federal and provincial, whose primary mandate is to wield effective influence in Ottawa on designing federal programs that redistribute toward the region.

Consider the evidence from the two federal elections conducted in the 1990s. While in opposition, the federal Liberals were ambiguous as to their own fiscal intentions; they were, however, highly critical of the modest exercise in fiscal restraint undertaken by their Progressive Conservative opponents.[23] In 1993, the federal Liberals captured 31 of the 32 Atlantic Canadian constituencies. Atlantic Canadians perceived the 1995/96 federal budget (which reduced intergovernmental transfers other than equalization) and the 1996 reform of unemployment insurance (which reduced the interregional transfer bias of the program) as fundamental violations of regional political expectations. In the 1997 federal election, regional hostility to federal policies resulted in the Liberals' losing two-thirds of their regional caucus: a decline from 31 to 11.

A few qualifications of these generalizations are in order here.

Over the past decade, leaders of the government of New Brunswick have regularly argued the case for less reliance on federal transfers. Among Atlantic provinces, its ratio of "own initiatives" to "own deficit," at 0.62, is closer to that of British Columbia than to the index values for the three other Atlantic provinces. And its provincial-debt-to-GDP ratio is the lowest in the region (except for the very small province of Prince Edward Island).

23 For example, the Liberals' Red Book ridiculed the Conservatives for having "set another unrealistic target [in the 1993/94 budget] by promising to eliminate the deficit in the next five years" (Liberal Party of Canada 1993, 20). Ironically, meeting that "unrealistic target" contributed to Liberal electoral success — at least outside Atlantic Canada — in 1997.

Table 5: *Tax-Supported Debt as a Percentage of Provincial GDP, 1992 and 1999*

	March 31, 1992		March 31, 1999		Change (3 – 1)
	(1)	(2)	(3)	(4)	(5)
	(percent)	*(rank)*	*(percent)*	*(rank)*	*(% points)*
Newfoundland	51	2	47	3	– 4
Nova Scotia	42	3	49	2	7
Prince Edward Island	32	4	31	5	– 1
New Brunswick	31	6	34	4	3
Quebec	24	8	50[a]	1	26
Ontario	20	9	29	7	9
Manitoba	25	7	25	8	0
Saskatchewan	55	1	30	6	– 25
Alberta	31	6	13	10	– 18
British Columbia	15	10	22	9	7

[a] Moody's provides two ratios for Quebec in 1999. The 50 percent figure includes an assessment of all the province's obligations to public employee pension funds. Excluding nonmarketable promises to these funds lowers the ratio to 36 percent.

Sources: Saskatchewan 1993; Moody's Investors Services 2000.

The new Nova Scotia government, elected in 1999, has promised fiscal redress. It has severely criticized the misleading presentation of provincial finances by the previous government, which used extensive offline budgeting (see the Appendix). Revisions to provincial accounting procedures announced in the fall 1999 budget have transformed reported surpluses for fiscal years 1996/97 to 1998/99 into sizable deficits.[24]

Influential Public Sector Unions

Provinces in which public sector unions exercise an influential political role have experienced above-average program spending increases, have polarized political cultures, and have made slow progress toward fiscal balance.

Public sector unions are an interest group with an obvious and overwhelming short-term commitment to increased program spending. When they exercise powerful influence within a governing political party, the cabinet has grave difficulty in

24 The primary reason for revising the province's public accounts was to eliminate much offline accounting for ongoing program expenditures. Overall, the Nova Scotia Ministry of Finance made the following changes: a $115 million deficit, instead of an $8 million surplus, in 1996/97; a $245 million deficit, instead of a $39 million surplus, in 1997/98; and a $384 million deficit, instead of a $23 million surplus, in 1998/99 (Nova Scotia 1999). Panel A in Figures 7, 8, 9, and 10 incorporate the Nova Scotia accounting adjustments for 1996/97 to 1998/99. This introduces a minor discontinuity in the time series.

Like Nova Scotia, New Brunswick made important accounting changes in 1999, and announced its intention of relieving New Brunswick Power, the provincial Crown corporation, of responsibility for a major liability. Unlike Nova Scotia, New Brunswick did not table a budget in fall 1999, so this decision is not reflected in Figures 7 to 10.

undertaking an efficient calculus to assess the benefit to be derived from incremental spending relative to the cost from incremental taxes. Among senior governments of the past decade, union influence has been pronounced in the New Democratic Party (NDP) governments of Ontario and British Columbia.

Elected to office in 1985, the Ontario Liberals governed during an economic boom.[25] Enjoying high revenue growth in the prosperous second half of the 1980s, they enhanced the generosity of social programs and established a trend of rapidly rising program spending.[26] The labor-backed NDP defeated the Liberals in mid-1990 and governed until defeated by the Conservatives in 1995. Faced with recession and pressured by union allies, the NDP increased program spending by a third between 1989/90 and 1992/93. In the reference year, 1991/92, Ontario accounted for a fifth of the combined federal-provincial deficit (see Figure 9 and Table 4).

In late 1992, the Ontario cabinet came to the reasonable decision that fiscal restraint was urgent, and in 1993 it attempted to negotiate acquiescence from union allies to a so-called social contract, an agreement to reduce public sector salaries in exchange for job security. The unions balked, and, amid widespread labor unrest, the government imposed payroll cuts by legislation. These cuts enabled the government to stabilize program spending but did little to reduce the deficit. The controversy effectively destroyed public confidence in the managerial competence of the provincial NDP and persuaded a plurality of voters in the two subsequent elections (1995 and 1999) to opt for a regime determined to end union influence on public finances.[27]

Public sector unions have conducted strikes to preserve former advantages, but the electoral results reveal little support for their agenda

Since the election of the Conservatives, aggregate Ontario program spending has remained essentially constant. Simply preventing spending increases has required aggressive collective bargaining by the government. Public sector unions have conducted strikes to preserve former advantages, but the electoral results reveal little support for their agenda or for the NDP, the party in Queen's Park most sympathetic to their agenda.[28] Thanks to above-average economic growth, Ontario's own-source revenues have increased since 1995 at a rate faster than that for the average senior government, despite tax-rate reductions.

The other province in which public sector unions have enjoyed intimate access to the governing caucus and cabinet is British Columbia. There, the NDP came to office in 1991, and was re-elected in 1996. Between 1990/91, the last fiscal year of its Social Credit predecessors, and 1995/96, the last year of its first term, the NDP increased program spending by a third. In their second term, program spending increases have been much more modest. While its NDP government has incurred continuous deficits

25 Initially, the Liberals formed a minority government dependent on provincial NDP support.

26 In part, Ontario's rapidly rising social program spending in the second half of the 1980s was due to incentives present in federal transfer programs. Prior to 1990, Ottawa assumed half of all provincial spending on social assistance under the shared-cost formula of the CAP. In response to escalating CAP transfers to Ontario — and to the federal deficit — Ottawa that year "capped" the rate of increase of these transfers to the three "have" provinces of Ontario, Alberta, and British Columbia.

27 Among the most illuminating accounts of the NDP's fiscal policy in Ontario are the two books written by former premier Bob Rae (1996; 1998). Rae is blunt in assessing the fiscal difficulties posed to his government by several major unions in the province. For the perspective of one of those unions, see Hargrove (1998).

28 In 1995, the NDP's popular vote dropped by approximately half of what the party garnered in 1990, the year it was elected to govern. In 1999, its vote dropped by a third relative to 1995, and the NDP caucus was too small to qualify the party for official status at Queen's Park.

since coming to office, British Columbia still has a favorable ranking among provinces in terms of taxpayer supported debt relative to provincial GDP (see Table 5). The explanation is that the government combined its large spending increases with large increases in own-source revenues.[29]

As in Ontario, the NDP in British Columbia has polarized the domestic political culture, lowering social consensus and increasing the political difficulty of effecting the political compromises required to balance provincial accounts. At time of writing (April 2000), the Liberals, who are the official opposition in Victoria, enjoy a large opinion poll advantage and will probably win the next election. In attempting to balance the budget, a future government may well face conflict analogous to Ontario's post–1993 experience. It will need to constrain spending, accede to majority pressure to reduce tax rates, and it will probably face bitter opposition from public sector unions.

Ontario and British Columbia display certain parallels. Union-backed governments undertook above-average increases in spending, which were followed by a collapse in social consensus around tax and spending decisions.

The fiscal history of Ontario and British Columbia displays certain parallels. Union-backed governments undertook above-average increases in spending, which were followed by a collapse in social consensus around tax and spending decisions. The two provinces are among the last to realize fiscal balance.

The Conflict between Ottawa and Quebec

The inability to resolve the conflict between Ottawa's nation-building strategies and Quebec nationalism exacerbated fiscal distress.

For decades, Ottawa has used transfer programs as a device to secure popular support in Quebec for the political status quo; their magnitude is one component in any explanation of the persistence of Ottawa's deficits. Within the province, the conflict between federalists and sovereigntists induced Quebec governments, both federalist and sovereigntist, to defer the politically difficult exercise of fiscal redress.

In the early years of the decade, the Quebec government increased spending at a rate well above the average of the 11 senior governments (although not as dramatically as the Ontario government did). Quebec accounted for 8 percent of the combined federal-provincial deficit in the reference fiscal year 1991/92, and by 1993/94 its deficit had fallen below the average for senior governments. Elected in 1994 and committed to winning a sovereignty referendum, the Parti Québécois (PQ) under Jacques Parizeau further delayed fiscal redress, sharply criticized federal Finance Minister Paul Martin's 1995 budget, and argued that a sovereign Quebec would not reduce social spending.

Finally, under Parizeau's successor, Lucien Bouchard, Quebec addressed its fiscal deficit. It has now achieved fiscal balance — and the dubious status of becoming the province with the highest ratio of tax-supported provincial debt to provincial GDP.

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29 In British Columbia, more than in most jurisdictions, the public accounts data present an incomplete summary of government activities. The province has used offline accounting extensively to reduce the deficit recorded on the consolidated revenue fund. Were the deficit defined as the increase in taxpayer-supported debt, the 1998/99 deficit would be 9 percent of program spending, not 3 percent as reported (British Columbia 1999a). A recent report recommends major changes in the province's accounting policy, including expansion of the scope of the consolidated account in order that the published fiscal balance reflect more accurately the divergence between accrued fiscal expenditures and revenues in any fiscal year and publication of a reconciliation between the announced deficit or surplus and the actual change in taxpayer-supported debt (British Columbia 1999b).

Bouchard's strategy relied on provincial traditions of interest-group cooperation at the peak level. The Quebec government undertook extensive interest-group consultation across a broad spectrum and secured widespread support for a campaign to balance the provincial budget prior to 2000 (Tremblay 1997). Thanks to unexpected increases in federal transfers, Quebec achieved a balanced budget one year earlier.

Quebec avoided entrenched public sector union opposition to fiscal redress, as took place in Ontario. Having achieved fiscal balance, however, the PQ government immediately faced a high-profile strike among nurses in summer 1999 as part of a coordinated union attempt to stake the claim of public sector workers to projected budgetary surpluses.

The Composition of Parliament

> ***A key to explaining Ottawa's fiscal redress is that the 1993 federal election served as a double referendum — on the Progressive Conservative government in Ottawa and on NDP governments in Ontario and British Columbia.***

The first five conclusions generalize about provincial fiscal experience; this last point illustrates the complex links between the public response to fiscal policies pursued by both orders of government.

The 1993 federal election made fiscal redress more feasible by eliminating from Parliament many members who were committed to past fiscal policies.

The 1993 federal election made fiscal redress more feasible by eliminating from Parliament many members who, for divergent reasons, were committed to past fiscal policies. In their initial budget (for 1994/95), the governing Liberals vindicated pessimistic expectations by extrapolating the spending levels of their Conservative predecessors. But for their second budget (1995/96), the Liberals undertook a politically painful process to cut established programs and launch a credible exercise in fiscal redress (see Savoie 1999 for details).

The obvious question is, why did Ottawa finally break with past budgeting traditions? An initial answer is simply that financial markets' skepticism over federal fiscal policy finally tipped the relative influence within the governing cabinet and caucus between those who wanted to continue past practices and those who wanted fiscal redress. The 1994/95 budget generated an immediate rise in interest rates that disrupted caucus and cabinet complacency. In the battle for hearts and minds — particularly those of the newly elected Liberal caucus — the Finance Department published an elaborate series of monographs during 1994 advocating restraint.[30] Late that year came the collapse of the Mexican peso, which illustrated the danger of ignoring a large public sector debt and which, by all accounts, was a significant factor in changing the minds of many in the Liberal caucus.

To push the discussion further, it is important to realize that the 1993 election produced a Parliament much easier to tip than its predecessors. It broke the influence of interest groups committed to maintaining former spending levels, and it shifted the composition of Parliament toward fiscal realists.

30 The most persuasive was undoubtedly *A New Framework for Economic Policy* (Canada 1994).

Voters rejected the federal Progressive Conservatives in 1993 for reasons that varied across the country. In Ontario, Quebec, and Atlantic Canada, the reasons did not bear centrally on fiscal matters. In the two westernmost provinces, however, Ottawa's fiscal policy mattered. The beneficiary of Conservative electoral losses was not the Liberal Party but the Reform Party. A core argument of Reformers was to end the federal deficit promptly by means of reductions in program spending and, in particular, reductions in regional transfers from the provinces west of Ottawa to those east of it.

Less obviously, the 1993 federal election was also a referendum on the influence of Canada's unions on fiscal policy.[31] Following elections held in Ontario, British Columbia, and Saskatchewan in 1990 and 1991, provincial NDP caucuses governed the majority of Canadians. The NDP has a long tradition of broad community support in Saskatchewan; in the two other provinces, union influence within the NDP was pronounced, as already noted. NDP governments in British Columbia and Ontario alienated voters, who then used the 1993 federal election as a plebiscite on their respective provincial governments. In Ontario, federal voters substituted the Liberals for the NDP; in British Columbia, voters elected a few Liberals and many Reformers to replace the NDP. The result of this "referendum" was the federal NDP's loss of four-fifths of its 1988 caucus and of any meaningful parliamentary influence.

NDP governments in British Columbia and Ontario alienated voters, who then used the 1993 federal election as a plebiscite on their respective provincial governments.

Recommendations

Unlike Belgium and Italy, Canada has no external constraint obliging politicians to undertake fiscal redress. Fortunately, a number of events have cumulatively had an equivalent effect. First chronologically were precedent-setting budgetary decisions made early in the decade by Prairie governments. Changes in composition of Parliament in the 1993 federal election mattered, as did particular events of 1994 such as the Mexican peso crisis. Combined, these events enabled the federal finance minister to prevail on cabinet and produce the seminal fiscal year 1995/96 budget. Distancing organized labor from the cabinet room at Queen's Park and Quebecers' rejecting, however narrowly, the sovereigntist option were preconditions for the two largest provinces to address their respective deficits.

But what of the future? Surely, it behooves us to avoid repeating the fiscal policies that led to protracted deficits and a wrenching decade of fiscal redress. What follows is an attempt to provide political rules of thumb in order that the next quarter-century turn out to be fiscally better than the last.

31 In aggregate, the federal NDP's popular vote fell by two-thirds between the elections of 1988 and 1993, and the party lost four-fifths of its caucus; the losses were concentrated in Ontario and British Columbia. To appreciate the effect of provincial NDP governments on the federal NDP vote, consider the party's divergent fortunes in the four provinces where the party historically has mattered (in the sense that it has governed). In Manitoba, a province not governed by the NDP at the time of the 1993 election, the party's share of the popular vote fell by roughly a fifth from what it obtained in 1988. If one takes the NDP's performance in Manitoba as a rough estimate of strategic voting among NDP voters who wanted rid of the Conservatives, the size of the residual suggests the extent of voters' dissatisfaction with their NDP government. In Saskatchewan, the NDP vote declined by roughly two-fifths, while in British Columbia and Ontario, the decline exceeded three-fifths.

Recommendation 1: Greater Tax and Expenditure Coincidence

Subject to the intergovernmental insurance afforded by equalization payments to "have-not" provinces, Canadians should insist on more respect for the principle of tax and expenditure coincidence than they have seen over the past quarter-century.

This principle has great significance for sustaining a cooperative political culture and for improving the quality of public programs. It encourages a political culture whereby interest groups conduct their collective activities subject to an implicit budget constraint: citizens get what they are prepared to pay via taxes. Moreover, it rewards political leaders who undertake the arduous political calculus of assessing the benefits of incremental spending against the costs of incremental taxation. If honored, the principle discourages the growth of a political culture whereby citizens reward politicians for interregional transfer aggrandizement.

For much of the past 25 years, the principle has been honored in the breach. Politicians at both levels campaigned on their relative ability to augment transfers from Ottawa to the relevant region. And each order of government blamed the other for its respective fiscal deficits. Throughout the 1980s and early 1990s, Ottawa, quite accurately, accused the provinces of spending in ways that maximized transfers to them; the provinces, again quite accurately, blamed Ottawa for disrupting provincial programming by *ad hoc* curtailing of the size of and conditions attached to its transfers. Neither order acknowledged its own responsibility for putting an end to deficit spending.

Ottawa, quite accurately, accused the provinces of spending in ways that maximized transfers to them; the provinces, again quite accurately, blamed Ottawa for disrupting provincial programming.

Not until the dynamic of mutual recrimination was muted and the 11 senior governments addressed their respective deficits did they also acknowledge serious accumulated inefficiencies in their respective programs. Many of the country's social programs that were put in place in the 1960s and 1970s received their first serious review only because financial difficulties were so acute that politicians could not procrastinate by blaming the other order of government.

There remains much more to do: two major areas in current turmoil are the management of provincial health care programs and seriously inadequate federal policies for addressing aboriginal poverty and social distress.

Yet it is worth acknowledging some of the achievements of the past decade. Here are three examples Ottawa undertook:

- *Employment insurance.* In its 1995 revision of the EI program, Ottawa introduced the intensity rule (which reduced benefits for repeat users) and increased work requirements for eligibility. The effect of these changes has been to bring the program closer to its initial goal, which is to provide social insurance against *unintended* unemployment, and curtailed the incentives within the program for firms and workers to pursue strategies of *intended* unemployment in seasonal employment sectors. These reforms have also reduced program overlap inasmuch as EI is now doing less to duplicate provincial social assistance as an income-support program.

- *Reduction of intergovernmental transfers and elimination of conditionality.* The decision in the 1995/96 budget to reduce the size of transfers enhanced the coincidence of

provincial taxing and spending decisions. The simultaneous decision to transform Ottawa's contribution to provincial social program funding into a block grant and eliminate cost sharing of social assistance (no more 50-cent dollars) removed a major distortion to provincial priorities. Both these decisions encouraged provincial politicians to improve program efficiency.

- *Conservation of remaining fish stocks*. Earlier I referred to the tragedy of the Atlantic cod fishery. To its credit, Ottawa resolved not to repeat the ecological catastrophe with the Pacific salmon fishery. It has borne the political controversy entailed in reducing fishing effort on the west coast.

While these reforms have incited interest-group opposition, the provinces have borne the brunt of politically controversial social program redesign during the past decade. Again, three examples:

- *Restructuring health care programs*. The provinces have reduced hospital capacity and increased ambulatory services, and they have introduced elements of co-payment for programs subject to overuse (such as pharmaceutical drug insurance). Some provinces are experimenting with "internal markets" — the creation of competition among alternate providers, private and public, within the overall constraint of a single-payer insurance system.[32] These restructuring programs have been controversial — Alberta's Bill 11 is the most prominent and controversial example — and are far from complete.

The moral dilemmas posed by programs directed to the poor are often acute, and political debate over policy change is often passionate.

- *Antipoverty policy*. The moral dilemmas posed by programs directed to the poor are often acute, and political debate over policy change is often passionate. Knowing this, politicians procrastinated in re-evaluating social assistance policy until the 1990s. The combination of a doubling of the proportion of Canadians in receipt of social assistance from the mid-1970s to mid-1990s and the fiscal crisis obliged the provinces to address the matter. Most concluded that benefits had become too generous, and untied generous benefits were not the best way to help the poor. The search for a better way has led provinces to experiment. Some have introduced earnings supplements to encourage paid employment among low-income parents; others have rendered welfare access much more difficult for able-bodied applicants.

- *Public sector compensation*. An important gain in public sector productivity during the past decade has come from the senior governments' having exercised more aggressive bargaining with their unionized employees. Staffing levels have been reduced, as has the premium of public over private sector compensation. Early in the decade, this premium was in the range of 10 to 20 percent (Brown 1994). By the end of the decade, aggressive bargaining has probably removed much of the premium in many provinces. Evidence on the public sector premium is sketchy, but a major study suggesting its erosion is the latest survey of the Institut de recherche et d'information en rémunération, which comprehensively compares public and private sector remuneration in Quebec. Its 14th annual survey, conducted in 1998,

32 For a discussion of internal markets in the context of Canadian health programming, see Jérôme-Forget and Forget (1998).

for the first time finds parity between global compensation (salary plus benefits) of those working for the provincial government and those working in the provincial private sector (Quebec 1998).

Each of these six reforms is clearly incomplete. Each will require further — often controversial — initiatives to realize the full potential. The temptation is great for aggrieved interest groups to lobby that the relevant government cease program reform and restore the former program design and level of spending. Given Ottawa's newfound fiscal surpluses, this tactic is an obvious one for interest groups operating at the center. At the provincial level, aggrieved interest groups seek to forestall reform and avoid the painful tradeoffs inherent in a provincial budget constraint by arguing that their expectations can be met by restoring former levels of intergovernmental transfers.

Recommendation 2: Tighter Constraint on Ottawa's Use of Its Spending Power

> *Ottawa and the provinces should re-examine the role of the federal spending power. For it to be a useful and legitimate institution, it must be subject to increased provincial consensus before Ottawa spends in areas of provincial jurisdiction. The obvious solution is to revisit the Social Union Agreement, a first version of which was signed in 1999.*

Public expectations for additional spending are primarily in domains, such as health and education, that lie within provincial jurisdiction. Since Ottawa now enjoys surpluses, interest-group pressure is intense for federal politicians to satisfy this demand by launching high-profile pan-Canadian programs (such as the Millennium Scholarship Fund, national pharmacare, or proposals for early childhood education). To do so would entail duplication with provincial programs and muddled political accountability for outcomes. If a dynamic ensues in which federal politicians consistently get to wear the white hats of spenders and provincial politicians are condemned to wear the black hats of budget cutters, the result is predictable: the provinces will refuse to play their role. They will put an end to the program reforms that they have been undertaking slowly and often with great political controversy. Overall, the quality of Canada's social programming will suffer.

Among the positive outcomes from Ottawa's 1995 fiscal initiatives was a concerted examination by the provinces of the appropriate rules that should govern the Canadian social union.

Among the positive outcomes from Ottawa's 1995 fiscal initiatives was a concerted examination by the provinces of the appropriate rules that should govern the Canadian social union — in particular, rules to govern the federal government's exercise of its spending power in areas of provincial jurisdiction. The two key documents in this exercise were the late-1995 *Report to the Premiers* and the "Provincial Consensus" prepared by mid-1998. This second document described a "provincial/territorial consensus on suggested means of better managing the common interests of governments in areas where interdependencies exist" (p. 1). It called for joint priority setting and outcome reporting. It deplored (p. 4) that

> the practice of Canadian federalism has, over time, confused the roles and responsibilities of the two orders of government. This confusion undermines public accountability. Greater clarification would enhance collaboration between

> governments and increase the public's understanding of which order of government is responsible for the delivery of social programs.

Although the Quebec government did not directly participate in elaborating either document, it subsequently endorsed the "Provincial Consensus."[33]

The core expectations among the provinces were to establish reasonable rules for the exercise of the federal spending power and to entrench joint federal-provincial responsibility for future national social programs. Burelle summarizes these expectations as follows:

> codecision by the partners in the federation in order to establish common objectives and minimum standards that each legislature [Ottawa and the provinces] must respect in exercise of its sovereign powers....These standards could be decided, based on European precedents, by a Council of first ministers. Establishing voting rules for the Council would require unanimity among the eleven partners in the federation because, initially, each partner would be in a position of sovereignty. The voting rules could range from a requirement of unanimity through qualified majority (e.g. seven provinces representing more than half Canada's population) to a simple majority; Ottawa might exercise a veto, when its own exclusive and sovereign powers are at stake. (2000, 93.)

Unfortunately, Ottawa's response to this interprovincial exercise was an aggressive defense of its own prerogatives. The agreement signed by nine provinces (all except Quebec) in February 1999 was, in all essentials, drafted to satisfy Ottawa's agenda; much of the provincial agenda lay on the cutting room floor.[34] Elsewhere, I criticize Ottawa's tactical offer of increased federal transfers under the CHST as an inducement to the provinces to abandon meaningful provincial constraint on exercise of the federal spending power and to vitiate joint federal-provincial co-decision for future pan-Canadian social programs (Richards 1999). Ironically, by the end of negotiations, Quebec found itself the only province continuing to adhere to the interprovincial consensus of 1998.

Ironically, by the end of negotiations, Quebec found itself the only province continuing to adhere to the interprovincial consensus of 1998.

Burelle criticizes the agreement on grounds similar to mine. Claude Ryan (1999) makes the obvious argument that, lacking Quebec's signature, any standards negotiated under the agreement cannot be truly national.

In defense of Ottawa's ability to spend freely on whatever Parliament deems appropriate, federal politicians make several arguments. Important to those who take this position is the idea that, in order to maintain national unity, Ottawa needs "to touch Canadians directly" and not leave delivery of all programs to the provinces.

The first point in reply is simply that Ottawa already delivers many social programs, from unemployment insurance to old age and child benefits, programs that

33 The *Report to the Premiers* was prepared by officials representing nine provinces — all except Quebec, which at the time was engaged in its sovereignty referendum. The quotation is from the second, the "Provincial Consensus." Although never published, the document circulated widely among the policy community.

34 As late as January 1999, the provinces remained more or less united behind a draft agreement reasonably close to the "Provincial Consensus." This penultimate draft has now been published (Gagnon and Segal 2000, 229–241).

lie within its constitutional orbit. If Ottawa is constrained in introducing new social programs, that does not eliminate its ability to undertake social programming that "touches Canadians."

Furthermore, in most domains beyond social programming, Ottawa enjoys unambiguous jurisdiction. An example is defense, a function that has assumed increasing importance given Canada's growing participation in peacekeeping efforts. Relative to most industrial countries, Canada's defense spending is low.

Another domain for an increased federal role is infrastructure. A good case exists that Canada should spend more on infrastructure (Richards and Vining, forthcoming). Some infrastructure projects — for example, a fast-train link along the Quebec-Windsor corridor — may satisfy the criteria of enhancing efficiency and of symbolically allowing Ottawa to "touch Canadians directly."

To summarize the first two recommendations, the provinces do not need larger transfers from Ottawa. And Canadians do not need major new programs from Ottawa in areas of health, education, and welfare, all of which are under provincial jurisdiction. Canadians should require from their governments a greater respect for tax-spending coincidence and rules requiring a substantial measure of provincial consensus before Ottawa uses its spending power in areas of provincial jurisdiction. Robson bluntly states the argument as follows:

> The demand for more services and the need for more innovative approaches in Canada today are greatest in health, education, and welfare. These are areas where the provinces have both constitutional authority and, being closer to the action, better capacity for delivering services. Despite bitter complaints and dire predictions, cuts in federal transfers to the provinces have resulted in neither the collapse of medicare nor the disintegration of the country. (1998, 15.)

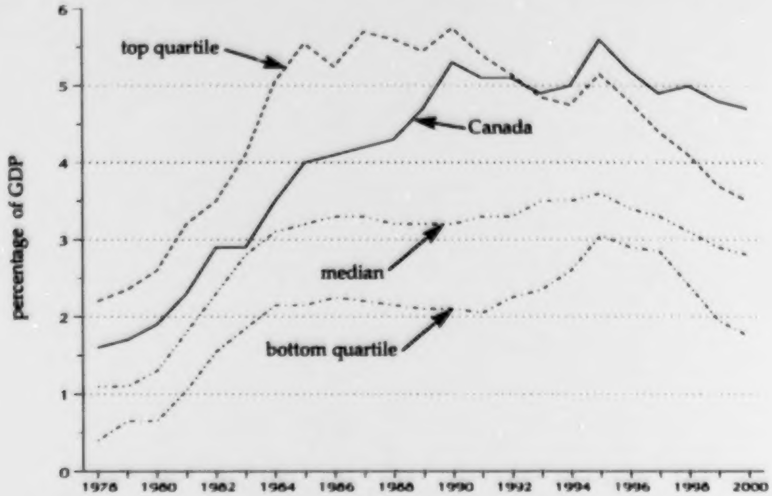
Recommendation 3: Stable Targets for Program Spending Relative to GDP

> *In aggregate, Canadian senior governments should now stabilize program spending as a share of GDP over the business cycle. In the short run, given that the economy is currently in the boom phase, Ottawa should entertain only limited spending growth, and undertake to reduce federal debt and taxes. The need for incremental spending lies primarily in areas of provincial jurisdiction; hence provincial spending should be less constrained. A reasonable short term-target is for Ottawa to pursue constant real per capita program spending and the provinces to increase their spending in line with GDP. (Given 3 percent real GDP growth, 1.2 percent population growth, and 1.5 percent inflation, the implication is that federal spending should grow by 2.7 percent and provincial program spending by 4.5 percent annually.)*

Budget-cutting politicians have performed valuable work in making the public coat fit the available cloth, but the magnitude of program spending reductions should serve as a warning before politicians cut more.

Budget-cutting politicians have performed valuable work in making the public coat fit the available cloth, but the magnitude of program spending reductions over the past decade should serve as a warning before politicians cut more. Probably, Canadians continue to be typical, in the sense that the distribution of their preferences about

Figure 11: ***Government Net Debt Interest Payments, 19 OECD Countries, 1978–2000***



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

generosity of public services is typical of OECD countries. Probably, Canada is also typical of OECD countries in the productivity that its public sector can realize.

Canada was more or less at the OECD median spending ratio over much of the past two decades. Redressing the fiscal deficit has forced it to become less typical. In 2000, Canadian public expenditures are projected to be about 4 percentage points below the median. And the median itself has declined since the early 1990s. In terms of quartiles, the projected 2000 distribution of public spending among the 19-country OECD sample is close to that for the early 1980s (refer back to Figure 3).

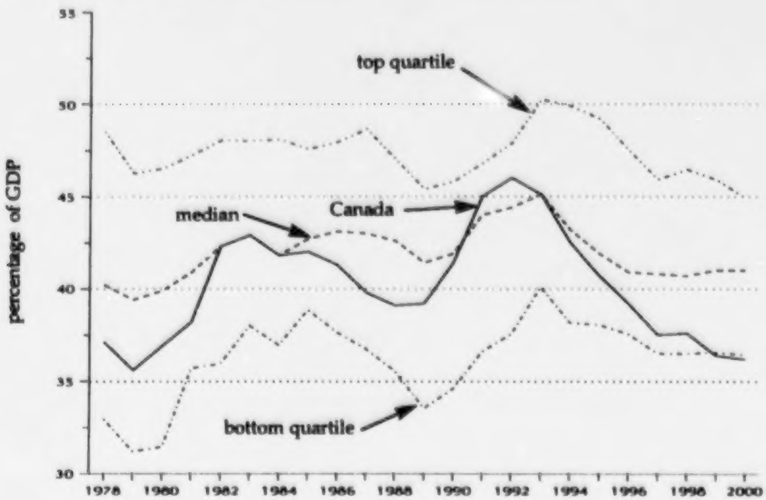
Canada's poor fiscal performance over the past quarter-century has given it exceptionally large debt-service costs.

Canada's poor fiscal performance over the past quarter-century has given it exceptionally large debt-service costs. Canada is in the top quarter of OECD countries by this measure. On a national accounts basis, Canada spends roughly 5 percent of GDP servicing its public debt, 2 percentage points more than the median. Subtracting debt servicing from public expenditures yields program spending. (See Figures 11 and 12.) Measured by the decline in program spending as share of GDP over the 1990s, Canada's program spending cuts rank third among OECD countries, somewhat less than in Finland and Sweden and similar to those undertaken in Norway.

After a decade of cutting the relative size of government, demands for new program spending have, not surprisingly, become more insistent. While the public demand is often led by narrow interests and the need is often vague because of inadequate program evaluation, governments cannot ignore widespread public concerns over selected programs. Inevitably, they will respond during this decade with spending increases larger than in the recent past. If judiciously planned, new program spending can do more than redistribute. Increased public investments in education and infrastructure may well be among the most efficient means of improving overall economic productivity.

In late 1999 (before the 2000/01 federal budget), the Royal Bank projected that Ottawa's fiscal surplus will rise to 2.2 percent of GDP by 2004/05. The two basic assumptions underlying this projection are that federal revenues will rise

Figure 12: *Program Spending, 19 OECD Countries, 1978–2000*



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

proportionately to GDP, while federal program spending rise more slowly but at a rate sufficient to maintain per capita spending constant in real terms. Under similar assumptions, the Royal Bank projects the provincial sector to realize a surplus of 1.4 percent of GDP by 2004/05 (McCallum 1999).

Extrapolating constant provincial per capita spending seems both undesirable and objectively unlikely. Under an alternate, more realistic scenario, the Royal Bank assumes provincial program spending will rise proportionately to GDP. In this scenario, the provinces will still realize an overall surplus by 2004/05, but it will be a very modest 0.3 percent of GDP. The Royal Bank study concludes with the rhetorical question, "What of the contention that Ottawa will get the money while the provinces will face the large spending needs?" to which it gives a cautious answer, "Our results suggest that there may be some truth in this contention" (ibid., 4).

If we accept the logic of the my first two recommendations, the conclusion can be less cautious. The provinces should undertake judicious increased spending in social programs and not be bound by as severe a spending limit as Ottawa.

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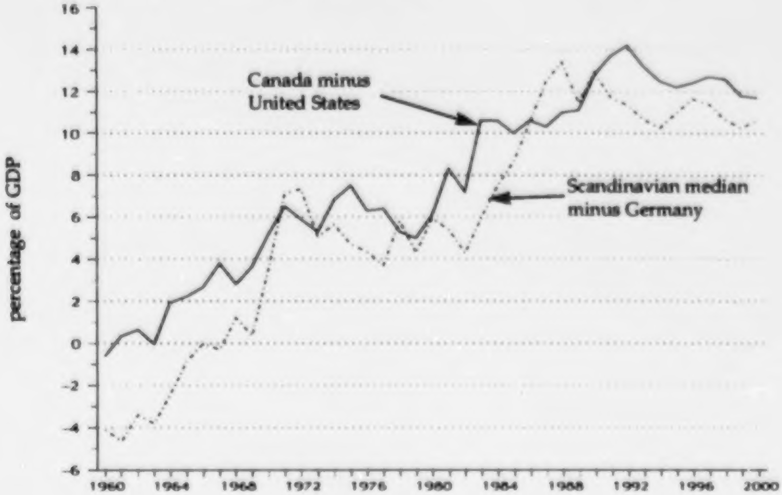
Recommendation 4: Lower Tax Rates

Canadian governments should consider reducing their tax revenues by up to 2 percentage points of GDP; Ottawa should take the lead.

Across particular countries, differences in political culture matter in the willingness to pay taxes — up to a point. Figure 13 traces the tax gaps among two sets of countries that are in close cultural and geographic proximity and, as a consequence, engage in extensive regional trade: first, the United States and Canada and, second, Germany and Scandinavia. In both instances, the tax gaps were less than 5 percentage points of GDP in the 1960s but increased as Canada and Scandinavia created welfare states more

Figure 13: ***Tax Gaps, Canada vs. United States and Scandinavia vs. Germany, 1960–2000***



Source: Author's calculations from data in *OECD Economic Outlook*, various issues through no. 66 (December 1999).

generous than those in their large respective neighbors. Having peaked near 14 percentage points, these tax gaps have fallen back to the 10 to 12 point range.

The current Canada–US tax gap of 12 percentage points is not a hard constraint, but the 1990s' halt to growing divergence is more than a statistical accident. Differences in political culture between countries enable long-term divergence in relative size of government, but beyond some threshold, the political and economic costs of that difference become pronounced. The political costs of divergence emerge in the high-tax country when the gap for a particular group becomes large enough to elicit politically vocal opposition. The economic costs induced by taxes depend on both their average and their marginal rates. The incremental cost to the economy of higher rates is not linear.[35] Hence, the relative economic cost of a tax gap between countries rises with the size of the gap.

In recent years, Canada has generated, on a national accounts basis, surpluses amounting to nearly 2 percent of GDP. If, as a first approximation, the present federal-provincial tax regime generates a constant government share of GDP (that is, revenues grow at a similar rate to GDP) and if the senior governments henceforth constrain spending growth to the range suggested in recommendation 3, then the margin within which to juggle tax cuts and debt repayment is about 2 percent of GDP.[36]

35 In a discussion of the literature on this subject, Kesselman (1999) says, in summary, that the efficiency cost of increasing marginal tax rates rises with the square of the marginal rate. The net economic cost of taxation depends on what government does with the tax revenue. If, for example, government programs offset a significant market failure, the net effect may be to enhance overall efficiency.

36 This simple exercise ignores an important aspect of medium term federal budgeting: the need to maintain a federal surplus sufficient to honor obligations incurred under the Canada and Quebec Pension Plans (CPP/QPP). To lower the steady-state premium level required to honor those pension obligations, Ottawa and the provinces agreed in 1997 to accelerate the schedule of contribution rate increases and thereby realize a significant surplus in the CPP/QPP account over the next decade (Robson, Mintz, and Poschmann 2000, 14).

Since the reference fiscal year 1991/92, the provincial sector's "own initiatives" have exceeded its share of the deficit. Nonetheless, the provinces remained in deficit in 1998/99, and the federal Finance Department projects a small aggregate provincial deficit for 1999/2000. By contrast, Ottawa, whose deficit relative to its programs spending in 1991/92 was much more severe, has recorded three successive surpluses (1997/98 to 1999/2000) and projects a fourth (Canada 2000, 19, 171. The explanation for this seeming paradox is twofold: a much larger increase in provincial debt-service costs relative to Ottawa's and a reduction in federal transfers to the provinces since 1991/92 (see Figure 10 and Table 3).

Tax reductions contained in the 2000/01 federal budget are an appropriate first step to implementing this recommendation. To reduce general tax rates at the federal level is a better way of easing the fiscal pressures on provinces than to bypass my first recommendation with *ad hoc* increases to intergovernmental transfers. If, in order to realize program reforms, particular provinces need revenues above those generated by current tax rates, they should increase their own tax rates, rather than lobby Ottawa.

Federal tax cuts plus — if necessary — provincial increases is a combination that respects the importance of tax and spending coincidence. Equalization always remains as the intergovernmental insurance that "provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (*Constitution Act, 1982*, section 36(2)).

Conclusion

The spirit of these recommendations — in the sense Montesquieu used the term — is to respect the constitutional division of powers and maintain a fairly disentangled federalism.

The spirit of these recommendations — in the sense Montesquieu used the term — is to respect the constitutional division of powers and maintain a fairly disentangled federalism. More specifically, the recommendations call for resuscitating the 1998 "Provincial Consensus," a political compromise too quickly set aside. Some fear that doing this would result in Canada's suffering the indignity of checkerboard federalism with hugely disparate social programs across the provinces. The future being uncertain, such fears may be reasonable. But I doubt it.

Those who fear unequal outcomes across provinces would be more credible if they acknowledged that Ottawa's past use of its spending power exacerbated political divisions (because of its regional bias in spending), confused political accountability (because voters did not know who was responsible for any particular program), and encouraged the provinces to postpone fiscal redress (because they could blame Ottawa for unilateral cuts in transfers). The West became alienated from the East, and Quebec, while happy to accept fiscal generosity from Ottawa, has never — and will never — abandon its concerns for cultural and linguistic survival.

The next priority in social policy is to rethink and redesign programs. That exercise will advance more expeditiously if budget cutters declare victory and haul down the sword of Damocles they have held over the heads of the senior governments. Admittedly, one or two laggards may still require its presence, but like the courtier of ancient Syracuse, most Canadian senior governments deserve to breathe a little easier.

Ending Canada's quarter-century of poor fiscal performance has been a complex exercise in reconciling inconsistent expectations across the country among interest groups about public spending and willingness to pay taxes. The reconciliation is not

perfect and never will be, but relative to the early 1990s, it is much improved. Unfortunately, memories are short and current surpluses are an inducement for Ottawa — and those provinces that are in surplus — to return to former fiscal habits. The relevant warning is that those who forget the past are often condemned to re-live it.

Appendix: A Primer on Government Budgeting

Government budgeting entails calculations based on accounting conventions and on political strategies. Unfortunately, alternate accounting conventions exist, and given the importance of budgets as statements of government intentions, politicians face an ongoing temptation to cook the books for strategic ends. Differing conventions and book-cooking devices rarely confuse professionals engaged by bond-rating agencies to assess the fiscal standing of governments, but they can readily frustrate public debate over fiscal matters.

Differing conventions and book-cooking devices rarely confuse professionals engaged by bond-rating agencies to assess the fiscal standing of governments, but they can readily frustrate public debate.

However imperfect government budgets are, they are the source of most information about government fiscal activity. What follows is a glossary introducing useful ideas for interpreting the numbers.

Accrual accounting. In principle, each of the 11 Canadian senior governments prepares its budget and accounts based on accrual accounting. The core concept of accrual accounting is that, in general, all revenues and expenditures be recorded online (see below) when the legislature approves them, regardless whether cash transactions occur at the time. This applies to both capital and current expenditures and to approved taxes and other levies.

Often, governments sin by delaying the recognition of expenditures incurred. However, the opposite sin has recently arisen. Having finally realized a fiscal surplus, the federal cabinet has been divided about priorities: should it spend more or reduce debt and taxes? Presumably to reduce the intensity of public scrutiny, Ottawa has recently chosen to record the future costs of announced programs in the current budget (including, for example, listing ten years of expenditures on the Millennium Scholarship Fund in the 1998/99 budget). This accounting practice distorts public interpretation of cabinet commitment to this program expenditure. The Millennium Scholarships are not a contractual obligation; they are analogous to most other operating programs, inasmuch as future cabinets may choose to modify program design and corresponding budget. (If spending on these scholarships is to be capitalized, one could equally argue for including ten years of projected future spending on many other programs.) The net effect of this decision is to exaggerate the annual tax revenues that the public perceives as required to maintain the current level of services.

National income accounting. In making international comparisons of governments' budgeting, agencies such as the OECD rely on national income accounting, a system intended to measure the current impact of government on economic activity. National income accounting emphasizes current cash expenditures and receipts; it differs from accrual accounting in omitting a number of deferred items, such as governments' future pension obligations to their civil servants.

Also, the OECD national income accounts gross up government revenues and expenditures to include major tax expenditures. Thus, for example, OECD data differ from Ottawa's reported budgets in accounting for major targeted child benefit programs. The former record gross federal income tax revenue and include targeted child benefit programs as explicit program expenditures, whereas the latter treat such programs as tax expenditures, netting the cost against gross revenues and expenditures.

Differences in the size of the public sector from one country to another must be treated with care. The same program may, in one country, be an online tax-financed program, while, in another, it may be provided by private agents, perhaps subject to government regulation. Where the OECD data are particularly useful is in international comparison of changes over a number of years in size of public sectors across countries.

Online and offline expenditures. When government budgets are delivered, the most-cited number is usually the online budget balance, the difference between the sum of consolidated online revenues and online expenditures. In order to demonstrate sound fiscal management, politicians usually seek to present a positive online balance (or at least to minimize any online deficit).

In the case of self-financing government activities (such as commercial Crown corporations), separate offline budgeting is appropriate. Politicians are wont to abuse the offline-online distinction however. Using offline agencies to account for expenditures that sooner or later must be paid by taxpayers is a prevalent but misleading practice.

Using offline agencies to account for expenditures that sooner or later must be paid by taxpayers is a prevalent but misleading practice.

Government budgeting often displays a political cycle. A political party newly elected to office eliminates the offline practices of its predecessor, but over time, it too accumulates a number of dubious offline practices. I have no wish to impugn the future accounting integrity of the new Nova Scotia government, but recent events in that province illustrate one phase of the cycle. The new government, ushered in by the 1999 provincial election, eliminated large offline spending accounts, with the result that reported online surpluses for fiscal years 1996/97, 1997/98, and 1998/99 became sizable deficits. (Look back at footnote 24.)

In the case of self-financing activities, taxpayers retain ultimate responsibility for expenditures incurred and, on occasion, pay. In New Brunswick as in Nova Scotia, the governing party changed following a 1999 election. The new provincial government has relieved its Crown corporation, New Brunswick Power, of responsibility for a major capital loss, transforming a reported 1998/99 surplus into a deficit (Martin 1999).

The prevalence of inappropriate offline budgeting has prompted bond-rating agencies to prepare independent assessments of the public debts for which taxpayers are liable and those that, in normal circumstances, will be paid via other sources, such as the revenues of commercial Crown corporations. In turn, such assessments permit a more realistic definition of a budget surplus as a decline in taxpayer-supported debt (and a budget deficit as an increase in it).

Tax expenditures. Governments may deliver programs via the tax-transfer system and net the expenditure against revenues. Such accounting does not affect the recorded budget balance, but it reduces the apparent size of government activities.

The most important Canadian example of a tax expenditure is to be found in Ottawa's accounting for its targeted child benefit programs (the goods and services tax credit and payments under the National Child Benefit System). Unlike benefits under the old family allowance, which were recorded as online program expenditures, these programs' expenditures are netted against tax revenues.

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